BUILDING THE MUNICIPAL CREDIT MARKET FOR INFRASTRUCTURE FINANCE: The Legal Framework

Prepared by:

Michael DeAngelis, Ronald W. Johnson, and
Christopher Z. Kaczmarski
Research Triangle Institute

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EXECUTIVE SUMMARY

This report presents findings and recommendations for improving the legal framework for municipal credit market development in Bulgaria. It is based upon a review of existing legislation and field work (including consultations with major stakeholders from both the public and private sectors) conducted during August 2002 by a municipal credit development team commissioned by the Research Triangle Institute under the LGI technical assistance program. The report takes account of the similar work completed toward the end of 1999, but concentrates on assessing the most feasible options for enhancing the policy and legal framework in line with the rapidly progressing fiscal decentralization process, which is presently being implemented by the Government of Bulgaria.

The issues presented in the report are wide ranging, yet the recommendations are specific and practical for policy and legislative initiatives. They are directed to the attention of Bulgarian policy makers and particularly the members of the newly established municipal borrowing working group, which has been vested by the government with responsibility for developing effective regulatory system in support of municipal credit market. It is anticipated that the report will serve as a clear guideline for discussions and determinations among members of municipal borrowing working group thus facilitating quick progress in development of a formal legislative proposal for Bulgaria.

Recognizing the constraints stemming from a lack of broad experience necessary to proceed with municipal credit market development in Bulgaria, the report strives to present to the readers as many pertinent foreign case studies, alternatives and adopted solutions as feasible in order to support the consultation process and to facilitate decisions.

Policy Overview

In an effort to define a national policy in support of municipal credit development the report identifies the following key policy considerations. Such national policy is a necessary prerequisite to formulation of appropriate laws and regulations.

- **Clear Underlying Objectives**

  - to prevent "wrongful borrowing"

  Borrowing by local governments that finance current-account deficits increases the stock of debt obligations that must be paid by future taxpayers without increasing productivity and means of repayment. Premature borrowing, before a municipality has established its creditworthiness or identified clear investment priorities, is likely to drain local budget resources and add risk to the fiscal system.

- to increase volume of municipal investments
At a time when governments at all levels in Bulgaria face severe budget constraints and there is insufficient funding of infrastructure by the central government, prudent borrowing can augment investment capacity. Additionally, the cost of capital expenditure can be spread among the years of a project's use as opposed to the entire project cost being included in the budget year of project construction.
- to establish regulatory order for control of developing municipal credit market
The development of a municipal credit market relates not only to the legal framework governing the borrowers, but also to the institutional regulatory environment for a variety of financial instruments including securities, as well as the regulatory environment governing the capital supply, i.e. banks, pension funds and securities dealers.

- **Importance of Addressing the Policy and Legal Framework before Municipal Lending Accelerates**
  Many other countries (other than Bulgaria where the municipal borrowing yet is relatively non-existing) have found themselves confronted with the reality of large-scale local borrowing, then have been obliged to try to construct *ex post* facto a legal framework that will accommodate the healthy borrowing that has occurred while curbing the excesses. Bulgaria is in a position to develop the legal and policy framework first, and to do so at a reasonable pace, in anticipation of upcoming market development. Bulgaria also can learn from risks that have become clear in other countries ranging from Brazil to Russia.

- **The Primacy of Fiscal Decentralization**
  The development of a local credit market is only feasible within a public finance system that assigns significant decision-making power and financing responsibility to local governments. Consistent and transparent sharing of revenues between central and local governments is of primary importance. On the other hand availability of a local credit market should help municipalities play a larger role in deciding on and implementing local capital investments.

- **The Importance of Municipal Creditworthiness Building**
  In order for municipal credit market to initiate and establish in sustainable manner more and more municipalities, and not just large municipalities need to become creditworthy to the banks financing institutions and investors. Creditworthiness of municipalities is largely defined by their ability to generate sufficient operating revenue surplus which could then be used for repayment of long-term capital debt obligations. The policy framework and respective regulatory system facilitating development of municipal credit market should therefore also encourage prudent management of real and financial assets of municipality as well as efficient utility operation and public service provision by the local governments.

Key Policy Considerations

The specific policy considerations relative to development of an effective municipal credit market in Bulgaria that need to be addressed by policy makers may be outlined as follows:

- **Facilitate equal competition between financial instruments utilized**
  There are some important distinctions between various debt instruments utilized in financing of the capital investment projects of the local governments. Among the most popular are the bank loans and general obligation municipal bonds. Variations of those instruments are also commonly known and used. Although historically some developed countries have had established preferential use of one set of instrument versus another, a country like Bulgaria newly embarking on development of a local credit market has no reason to legally choose one form of lending over another. The same basic legal framework can and should apply to all types of debt instruments without discriminating between them. Competition between banks, a bond market and other available financing instruments can help keep the costs of capital as low as possible for municipal borrowers.

- **Introduce more flexible forms of debt collateral**
  To lower the negative impact on local governments of presently practiced preoccupation of the lending institutions with physical collateral a shift shall be made towards general obligation and revenue based financing of for projects undertaken by creditworthy municipalities. Historically the most rapid development of the municipal credit markets has been observed in those countries that introduced most relaxed policies regarding necessity for securing municipal loans by physical collaterals.

- **Evaluate potential for central government intercepts**
  With the largest and most reliable source of revenue for the local governments in Bulgaria coming from the central government transfers it may become very useful to establish a legislatively authorized “intercepts” of such intergovernmental transfers. Such intercepts can greatly enhance local governments ability to offer extremely reliable security for their borrowing and can provide a strong boost to credit market development without any implied central government guarantee or other cost to the national treasury.

- **Implement tax law neutrality**
  As a rule, tax policy should: (i) ensure that municipal governments can compete for private capital on even terms with other public entities, and (ii) strive for neutrality among different forms of municipal debt instruments, i.e. non-preferential treatment of the investor in one form of debt

instrument over another, thus facilitating competition in the utilization of various instruments and a balanced development of the municipal credit market.

- **Define the proper Central Government role in Municipal Debt Issuance**
  Given the nascent stage of the market consideration should be given by the central government to subject municipal debt issuance in some circumstances, e.g. (i) for municipalities of less than a certain size; (ii) for municipalities that have default experience; (iii) for debt issued in a foreign currency; or (iv) to permit a municipality to exceed the debt limit. In addition the central government may wish to assume a more active role in stimulating credit market development by considering implementation of a nationally driven local government financing system such as those offered under a concept of a Municipal Development Fund.

- **Stimulate municipal credit market supply and demand**
  Although the supply side of the municipal credit market in Bulgaria appears to have sufficient liquidity and capacity to actively enter into numerous transactions providing that legal and regulatory enhancements pointed out in this report are analyzed and implemented, the demand side of the market is currently limited to larger municipalities with relatively strong economies. It is therefore of utmost importance for municipal credit market development that the coinciding fiscal decentralization program intended to strengthen the local government financing capacities, but also obligating municipalities to co-finance their capital investment projects in order to secure grant funding (e.g. from EU) proceeds as planned and without delays.

- **Support institution building**
  The legal reform strategy must be embedded in a larger policy framework that further clarifies the roles of the public and private-sector entities that are engaged in the operation of a municipal credit market and the related requirements for their institutional development, including governmental and other regulatory institutions related to credit markets.

Elements of a Comprehensive Law on Municipal Credit

In order for the legislative measures to cover the issue of municipal borrowing in a manner that is complete and comprehensive the authors of the report propose that the following elements are considered:

Municipal Authority to Borrow

Capital market confidence in the binding nature of a financial obligation on succeeding legislative bodies is an essential precondition for enlarging the availability of long term debt financing for municipal investment. This principle should be explicitly affirmed in any municipal credit legislation. The law itself should recite the binding nature of municipal obligation to repay debt that has been duly authorized. In addition the role of central government in some form of limited approval as to legal validity or other review might be considered at the early stages of municipal borrowing. However, it is more likely to be beneficial to establish an objective standard for a debt limitation, and limit any central government approval to certain types of financing that may justify more scrutiny (e.g. foreign currency debt, debt issued by municipalities that have defaulted in the past, etc).

Purpose of Borrowing

The legislation should provide that short-term financing, which shall be paid within the budget year, may be used to finance cash flow budget deficits, and that financing which extends beyond the current budget year may be issued solely for capital investment or refinancing of debt issued for capital investment that serves a "public purpose" authorized in the municipal budget.

Restrictions on the Issuance of Municipal Debt

There should be a debt service limitation provision; and the Government should terminate the practice of including an investment limit in the annual State Budget Acts. Both these recommendations are detailed and elaborated in the report, including preferable alternatives for achieving the objectives underlying the current investment limit.

Guarantees

Municipal guarantees of third party debt should be (i) authorized in the same manner as municipal debt; (ii)for projects for which municipal debt could be issued (i.e., “public purpose”); (iii)limited to third parties that are either created or controlled by the municipality; and (iv)should be counted towards the debt limitation in the same manner as direct debt, or some lesser percentage thereof for such time as the municipality has not paid on the guarantee.

Characteristics of Municipal Debt (Terms; Collateral)

The specific recommendations regarding regulations relative to terms of a debt, tax status of debt instruments, collateral (pledges, state transfer intercepts) and guarantees have been outlined in detail within the report for consideration by Bulgarian policy and law makers. All of these recommendations although detailed and specific in nature are intended to suggest broad regulatory enhancements consistent with international best practice and most compatible with pre-identified Bulgarian conditions.

Disclosure

Two types of disclosure standards are recommended for application in Bulgaria. One for the public offerings of municipal debt instruments (bonds) and second for private placements. Clear, fair, and enforceable disclosure requirements are central to municipal credit market regulation and efficiency. They also have an impact on the costs of bond issuance and the willingness of private financial advisers and other financial intermediaries to take on the entrepreneurial risks of bringing municipal offerings to the market. Standardization in the disclosure requirements themselves (and predictability, timeliness, and professionalism in the review process), will go far towards encouraging municipalities and their advisors to invest the time and resources involved in successfully preparing and marketing a bond issue. In designing disclosure regulations attention must be given to what information needs to be disclosed by whom, to whom, and when.

Prudential Investment of Proceeds

An important element of municipal credit analysis is the type of investments that are permitted for (i)the proceeds of a borrowing pending their application to the permitted purpose, and (ii)any funds that are held for the purpose of paying debt service., including reserve funds. In Bulgaria with the decision of the Constitutional Court, the requirement has been transformed from a relatively restrictive policy to a very broad policy, permitting almost any type of security. The term "prudential investment" might best be defined in an Ordinance, to reflect the changing availability of financial instruments. However, the investment of municipal funds should minimize credit risk and eliminate liquidity risk.

Lender Remedies in Event of Default

The type of well designed state transfer intercept recommended earlier, can provide lenders a more practical and reliable remedy in the event of default than enforcement of their rights through court action (or threat of such action).
Based on the above, at this time there does not appear a need for a municipal credit law to deal in detail with the type of lender remedies available pursuant to the commercial code and other civil procure legislation. However, in respect to the bondholders' standing to act in the event of default, the legal framework law should permit them to act in an organized and effective manner to enforce their rights.

Central Government Approval, Monitoring and Intervention

Caution should be exercised imposing prior central government review and approval for the issuance of municipal debt (other than for reporting and conformance with the disclosure requirements of the *Law on Public Offerings of Securities*). However, the law should direct municipal borrowers to notify the Ministry of Finance when a debt issue is imminent and to provide certification and documentation that the terms of the pending credit will not cause the municipality to exceed the statutory debt limit. Such notification would allow the MoF to maintain a current inventory of outstanding municipal debt, for purposes of both (i)enforcing the municipal debt service limit itself, (ii)monitoring aggregate municipal borrowing in conjunction with overall public debt management. In addition the law should stipulate that, in the event of a default on a municipal credit, both the municipality and the lender must give the central government "notice" of said default if the delinquent payment has not been made within pre-specified number of days of its due date.

Joint Municipal Associations

Joint Associations should be authorized by law to exercise the same legal authority as are common to its members, expressly providing that such associations may incur debt "on behalf of its members" in the same manner as its members. Each member of the association would authorize its share of such debt in accordance with the legal provisions covering debt.

Municipal Insolvency

Law and procedures should be developed for managing the affairs of an insolvent municipality and its relationships and rights with regard to creditors, and the priorities among them. The procedure should also include establishment of a set of policies to assist the local government to regain a stable financial position. Depending on the rules that are adopted, such procedures could be initiated by the council of Ministers, the local government itself, or eventually the municipality's creditors. The definition of municipal insolvency, as well as the rules and conditions under which a procedure to address municipal insolvency may be engaged should be very clearly determined.

Other Financial Sector Laws and Regulations

Banks

Although the volume of bank lending to municipalities to date is small, banks face no restrictions on the portion of their portfolios that they can allocate to municipal loans. However, several municipalities have given up on negotiations for bank loans because of what they perceived as unreasonably high requirements for collateral relative to loan value (often being in excess of 200 percent). This represents a significant constraint for the credit market development. On the other hand, in terms of bank regulatory system, banks are operating under 100% reserve requirement in relation to municipal lending. The substantial collateral and reserve requirements could, in the future, tend to make the purchase of municipal bonds more attractive to banks than primary lending to municipalities. To date, the bonds being issued have been unsecured and banks need only reserve against them as "investments" rather than as loans.

Pension Funds

The present legal framework regarding pension funds encourages investment in municipal bonds that are prudent investments. A number of the recommendations made in the report including the adoption of disclosure rules for such bonds, and full range of measures to strengthen the creditworthiness of the municipalities that would issue them, would be major steps in improving their attractiveness to pension fund managers.

Insurance Companies

The Insurance Act already provides for investment in municipal bonds. Thus the essential legal prerequisite is in place. As part of any overall review and revision of the Insurance Act that may be forthcoming in the future, the five percent limit (on municipal bonds as a per cent of reserves) might be reviewed and consideration given to enacting a modest increase (perhaps to 10 percent) or to shifting to a limit defined along the more flexible lines contained in the pension fund legislation.

INTRODUCTION

This Report presents the results of the study completed during the months of July and August, 2002 by the team of municipal credit development experts commissioned by the Research Triangle Institute under the USAID funded Bulgaria Local Government Initiative Program. The work of the experts has concentrated on analyzing the present policy, practice and regulatory framework existing in Bulgaria and the impacts of fiscal decentralization program currently being implemented by the Government of Bulgaria to assess the opportunities and formulate recommendations in support of municipal credit market development.

During the assignment the experts have met and interview over 40 individuals representing LGI's partner organizations, ministries, local government's and local government institutions as well representatives of banks private sector investors, pension funds, insurance companies and key domestic and international organizations interested in local credit market development.

As in all post-Communist Central and Eastern European (CEE) countries, Bulgarian local governments are faced with the challenge of remedying years of under-investment and under-maintenance in basic infrastructure and building stock, and of addressing stricter pollution control requirements.

The objective of this Report is to set forth various options for the essential elements of a municipal credit market, as well as the policy implications for such options. The design of the legal and regulatory environment for a municipal credit market should reflect the careful deliberation of the policy implications with regard to each element.

SECTION 1: A POLICY OVERVIEW

The following key policy considerations that should govern the development of a national policy in support of municipal credit market development. The development of appropriate laws and regulations to govern municipal credit market activities should take place within a larger policy framework based on the following considerations:

1.1. The Underlying Objective.

The promotion of more borrowing by municipal governments is clearly *not* an end in itself. Borrowing by local governments that finance current-account deficits increases the stock of debt obligations that must be paid by future taxpayers without increasing productivity and means of repayment. Premature borrowing, before a municipality has established its creditworthiness or identified clear investment priorities, is likely to drain local budget resources and add risk to the fiscal system.

The underlying purpose of municipal credit market development is to increase the volume of local capital investment in support of essential municipal services. At a time when governments at all levels in Bulgaria face severe budget constraints and there is insufficient funding of infrastructure by the central government, prudent borrowing can augment investment capacity. Additionally, the cost of capital expenditure can be spread among the years of a project's use as opposed to the entire project cost being included in the budget year of project construction. For example, well-designed investment and borrowing plans often can finance the construction of needed infrastructure facilities today, then repay the debt that is incurred from the future earnings of the facilities themselves through user charges or through cost savings in service operations.

The development of a municipal credit market relates not only to the legal framework governing the borrowers, but also to the institutional regulatory environment for a variety of financial instruments including securities, as well as the regulatory environment governing the capital supply, i.e. banks, pension funds and securities dealers.

1.2. Importance of Addressing the Policy and Legal Framework before Municipal Lending Accelerates.

For the moment, Bulgaria has the advantage that no explosion of local government borrowing is underway. Many other countries have found themselves confronted with the reality of large-scale local borrowing, then have been obliged to try to construct *ex post* facto a legal framework that will accommodate the healthy borrowing that has occurred while curbing the excesses. Bulgaria is in a position to develop the legal and policy framework first, and to do so at a reasonable pace, in anticipation of future market development. Bulgaria also can learn from risks that have become clear in other countries. From Brazil to Russia, excessive borrowing by sub-national governments, or debt issuance in the absence of an adequate legal framework (one that clarifies critical issues like the status of guarantees or the remedies available to lenders in the event of a municipality's non-payment) has exacerbated national economic crises. The promise of soundly based local borrowing is large, but the risks involved in badly prepared borrowing also are large. All parties (local governments, national government, banks, and potential investors in municipal debt) share an interest that the policy issues surrounding credit market development be well understood, and that an appropriate legal framework be in place before the market springs into action.

1.3. The Primacy of Fiscal Decentralization and for Building Municipal Creditworthiness.

Assigning a priority to local credit market development presupposes a government commitment to decentralize important parts of local public service delivery, along with the financing of such services and the capital facilities essential for their provision. Consistent and transparent sharing of revenues between central and local governments is of primary importance. In an efficiently decentralized system, municipalities will have some choice about the character of services they provide and the extent of local service coverage. They will have responsibility for raising at least part of the costs of service delivery at the local level, in the form of taxes or user fees. They will face the need to finance from own resources at least part of the capital costs required to upgrade or expand infrastructure networks, perhaps in collaboration with a central government that provides capital grants or other forms of co-financing. Finally, for decentralization to be a reality local authorities will need to have some flexibility as to local tax rates and local fee schedules, so that they can pay for the level of investment and service delivery that they have chosen.[1] In a decentralized system, local taxpayers have a good part of the final say in what levels of public services a municipality will provide, given the costs of service provision.

A development of a local credit market is only feasible within a public finance system that assigns significant decision-making power and financing responsibility to local governments. On the other hand availability of a local credit market should help municipalities play a larger role in deciding on and implementing local capital investments. The Government of Bulgaria has demonstrated its commitment to broad fiscal decentralization by the Council of Minister's approval in May 2002 of the proposed Fiscal Decentralization Concept and Program. Once approved by the National Assembly, the reforms to the Municipal Budget Act, the Local Taxes and Fees Act, and other laws governing intergovernmental relations will create a policy framework that enlarges local government revenue sources, clarifies expenditure responsibilities, and imposes greater fiscal discipline. These reforms will provide the broader framework in

[1] The constraints on the freedom of municipalities to set local taxes come (in addition to political and cultural traditions) from the Bulgarian constitution, which requires that the tax rates and base be set in an act of the Parliament.

which a municipal credit system can become a sustainable tool for local development.

SECTION 2: KEY POLICY CONSIDERATIONS

2.1. The Desirability of Competition between Financial Instruments.

Municipal debt instruments themselves can vary. A bank loan to a municipality is structured differently from a municipal bond that pension funds or other investors buy. However, different forms of credit can serve the same purpose of intermediate-term investment financing for a municipality. Historically, some parts of the world, like Western Europe, have relied more heavily on bank loans than bonds sold in the capital market for municipal credit financing, while other countries, like the United States, have relied more heavily on bonds. There are some important distinctions between the two instruments: a publicly sold municipal bond requires more publicly disclosed financial and other information than does a loan made by a bank. In a bank loan, information typically is disclosed only to the lenders. A country like Bulgaria, newly embarking on development of a local credit market, however, has no reason to legally choose one form of lending over another. The same basic legal framework can and should apply to all types of debt instruments without discriminating between them. Competition between banks, a bond market and other available financing instruments can help keep the costs of capital as low as possible for municipal borrowers.

However, in the early stages of market development certain instruments may be structured in a manner that is less complicated, less risky, more flexible and more competitive and thereby more desirable for the early stage of market development. Policy development with respect to more sophisticated and complex instruments may evolve as the market matures.

2.2. Forms of Debt Collateral.

A shift away from the present preoccupation with physical collateral and toward general obligation and revenue-based financing may well prove to be a significant precondition for sustained growth in the volume of private sector lending to local governments. Among the considerations that underlie this conclusion:

- As privatization continues, the amount of municipal "private" property available to pledge as collateral will continue to contract—particularly the inventory of property clearly suitable for transfer to the private sector.

- Experience in other countries suggests that in practice it is extremely difficult for private creditors to foreclose on pledges of municipal property in the event of serious loan defaults. Most developing and transitional countries tend to rely most heavily on general obligation financing –i.e., debt secured by a pledge of all of the local government's budget resources.

- Much local capital investment finds its justification in a proposed project's ability to decrease the costs of underlying public services. Here, reliance on real estate collateral detracts attention from the project's underlying economics. If loan repayment is predicated on revenues or cost savings to be generated from the project, both the municipal borrower and the lender tend to focus with more discipline on the economic costs and benefits of the proposed undertaking.

- For lenders, one potential attraction of municipal government borrowers (when compared with private sector firms) is their permanence and sizable and relatively predictable future revenue streams. In addition to local taxes and fees, future revenues include shared taxes and fees for essential public services

2.3. The Potential of Transfer Intercepts.

In Bulgaria, the largest and most reliable source of local revenues will remain for some time to come from the taxes collected by the central government and transferred to local governments—most importantly the shared personal income tax (PIT) and the own-source component of the corporate income tax (CIT). The 2002 State Budget Act allocates fifty percent (50%) of PIT revenues to the municipal budgets. Pursuant to the Corporate Income Tax Act, the own-source component of the CIT is ten percent (10%).

A number of countries use legislatively authorized "intercepts" of such intergovernmental transfers to enhance the ability of local governments to offer extremely reliable security for their borrowing. Such intercepts can provide a strong boost to credit market development without any implied central government guarantee or other cost to the national treasury. As such they merit particular consideration in the development of municipal credit policy and law. The recommendations section addresses these considerations, as well as problems associated with over reliance on this *de facto* form of credit enhancement, in further detail below.

2.4. Tax Law Neutrality.

In general, credit markets configure themselves to take the fullest advantage of tax policy. Tax laws, particularly exemptions for interest income, have a powerful effect on the development of municipal credit markets and the motivation for different categories of lenders and investors to participate in such markets. As a rule, tax policy should:

- Ensure that municipal governments can compete for private capital on even terms with other public entities.

- Strive for neutrality among different forms of municipal debt instruments, i.e. non-preferential treatment of the investor in one form of debt instrument over another, thus facilitating competition in the utilization of various instruments and a balanced development of the municipal credit market.

2.5. The Proper Central Government Role in Municipal Debt Issuance.

Municipal credit market policy should reflect the legitimate central government interest in the integrity of municipal budgeting and financial management. One fundamental interest is that municipalities provide the basic public services expected of them, before they invest in non-core activities. A second fundamental interest is that municipalities prepare and execute balanced operating budgets. In respect to the oversight of municipal credit, the central government has two critical concerns over and above ensuring compliance with legally mandated procedures:

- One interest is limiting the consolidated public sector's outstanding debt--to comply with international agreements, to preserve the government's ability to borrow abroad, and most importantly, to build a solid base for the national economy and future participation in the European Union. The consolidated public deficit includes the deficits of municipal governments; the outstanding stock of consolidated public sector debt includes the debt of municipalities. Although the debt of the Bulgarian public sector (which includes both sovereign and sub-sovereign debt) has been declining as a ratio of GDP, in 1999 it remained well above the limit of 60 percent established by the European Union for its members.

- To guard against highly imprudent borrowing that could threaten the integrity of the overall public finance system and put pressure on the national government to deliver costly bailouts.

Nonetheless, in drafting a municipal credit law, the authors caution against authorizing the Ministry of Finance to exercise prior restraint of municipal debt issuance. However, given the nascent stage of the market consideration should be given to subjecting municipal debt issuance in some circumstances, e.g. i) for municipalities of less than a certain size; ii) for municipalities that have default experience; iii) for debt issued in a foreign currency; or iv) to permit a municipality to exceed the debt limit.

In respect to management of aggregate public sector debt, it should be noted that, even though municipal budgets account for nearly 20 percent of all public sector spending in Bulgaria, total outstanding municipal borrowing represents a trivial portion (a fraction of one percent) of total public sector debt. For the near term, placing prior restraints on municipal borrowing will have no meaningful impact on lowering the overall public debt sector ratio.

At the heart of the rationale for private capital market development, is the confidence that the self-interest of banks and other financial institutions will motivate them to assess the ability of borrowers to repay their debts. To duplicate this function in the government requires sophisticated institutional capacity within the Ministry of Finance or another appropriate agency. Even when this institutional capacity exists, there is little reason to believe that the monitoring agency will do a better job of assessing credit risk than the lenders and the rating agencies (or, for that matter, the municipalities themselves). Moreover, central government review and approval of municipal credits can raise the specter of an implicit guarantee, with municipal bondholders or lenders likely to hold the oversight agency responsible in the event of a payment default.

Thus, the recommended reform strategy argues that the municipal credit legislation abstain from creating a new level of review and approval; except in certain circumstances. The recommendations of this report does address forms of legislated debt limits and monitoring that can provide some protection against local imprudence. The wisdom of this course could be reassessed in a few years in the light of further accumulated experience with municipal lending.

One role of the central government with regard to municipal credit that should be avoided is that of the central government as guarantor of municipal credit, either expressly through he issuance of guarantees, or impliedly through effectively “bailing-out” troubled municipalities. The moral hazards associated with such central government activities are well documented in many emerging markets. Although, practically certain international financial institutions many require such guarantees in connection with municipal lending, such guarantees should be carefully considered and limited to such circumstances.

2.5.1 A More Activist Role in Stimulating Credit Market Development. Policy for municipal credit market development should be informed by a clearly defined goal in respect to achieving a meaningful level of lending activity over the near term . Comparative international experience suggests that a private credit market is unlikely to coalesce without some triggering forms of assistance or intervention that can help capital market participants become familiar and comfortable with the underwriting of municipal credits, and make available longer-term credits (up to 20 years) that domestic lenders are presently unable to provide.

Certainly, technical assistance and training directed both at prospective municipal borrowers, commercial banks, and other financial institutions can make a useful contribution towards this objective. However, technical assistance alone may not prompt a significant expansion in private sector lending to municipalities. Moreover, even when municipal credit markets are functioning, certain small and medium size municipalities of marginal creditworthiness may not be able to access the private sector capital supply. Although mature local credit markets now are dominated by private-sector lenders, many developing and re-structuring nations have passed through a transitional stage when public institutions or arms of the national government played a role in most of the long-term lending to municipalities—often by on-lending funds loaned or guaranteed by an international donor.[2]

As Bulgaria's government weighs its policy options for actively facilitating municipal credit market development, it should consider the mixed lessons that can be drawn from this comparative international experience. On the one hand, a few countries have had, on balance, a positive experience with on-lending international donor funds through some form of "municipal bank" or "development fund". Brazil's municipal development funds lend directly to local governments; thus far they have an excellent record of repayment and have established some positive precedents for the private financial institutions that may follow their lead. The Czech MUFIS offers a relatively unique and exemplary model. MUFIS was established from its inception to operate as a second-tier, financial intermediary that extends a credit-line of medium-term funds to private, commercial banks. The banks in turn lend to municipal governments for infrastructure projects and assume 100 percent of the risk for the loans that they underwrite. Repayment history has been essentially default free and the program has motivated participating banks to expand municipal lending using their own resources.[3][4]

On the other hand, despite the success stories, as often as not, municipal development loan funds have compiled unacceptable default rates and ended-up competing with or actively interfering in private credit markets in ways that distort market incentives, and perpetuate public subsidies. Moreover, it is difficult to point to instructive models for how such finds should be wound down, once they have accomplished their initial purpose and a private municipal credit market has firmly established itself. Should they be dismantled or converted to perform some more modest, residual role (technical assistance provider, regulator, more narrow, special purpose lender)? Complicating this question, is that these municipal development funds typically have residual fiduciary obligations that may extend out as long as 30 years until the original donor credit is fully repaid, even though the initial infrastructure loans to participating municipal entities may all have been repaid within ten or fifteen years. "Although Municipal Development Funds in some parts of the world have celebrated their 25th anniversaries, they have largely remained captive instruments for on-lending funds provided by international institutions and central governments."[5]

[2] The majority of Western European nations have a similar legacy, with financing through long-term domestic funds. Some have only relatively recently privatized their municipal credit institutions (France, Belgium, Spain).

[3] A similar World Bank funded initiative in Poland has gotten off to a slow start. Yet another World Bank project modeled in large part on the Czech experience (twin local development funds for the Republic of Srpska and for Bosnia and Herzegovina) has just gotten underway.

[4] MUFIS perceives that it has already accomplished its initial objective of private credit market development; currently it is addressing the question of its medium term, residual role and fiduciary responsibility until the longer-term (30 year) donor credit is repaid.

[5] George E. Peterson, Building Local Credit Systems, Urban Management Program Discussion Paper, Urban Institute, May 1997.

Transitional countries at Bulgaria's early stage of credit market development confront a dilemma:

- The likelihood that some form of government on-lending fund may prove essential to jump-starting a significant level of infrastructure financing pr providing access to small and medium sized municipalities that will not be serviced by the private sector capiyal supply;

- Balanced against this realization, a substantial risk that, without an unusual degree of political and bureaucratic self-restraint, a local development fund could prove counter-productive to the objectives of sound, private credit market development.

If after carefully assessing the opportunities and the risks, the Government of Bulgaria should chose to create some form of Municipal Development Fund (that on-lends from an external credit line), it should do so with the clear intent:

- That the Fund be established for the sole purpose of supporting the development of a private credit market;

- That it operates through commercial banks who would assume the responsibility of underwriting the risk of infrastructure loans extended to participating communities;

- Related to the above points, that it be designed to operate swiftly and predictably, and to refrain from performing time-consuming independent project appraisals which needlessly delay project financing and construction by imposing a redundant layer of review, and which relieve banks and municipal borrowers of their proper decision making role.

2.6. Municipal Credit Market Supply and Demand.

To date, municipal lending activity has been minimal. The research identified only a handful of municipal credits in place, most with a maturity of only a year. The weakness of effective municipal demand poses the major constraint on municipal lending today. The market remains in a formative stage during which it can be hoped that a few of the larger cities (with relatively healthy economies) will participate in the credit markets and establish some sound precedents for future growth in municipal lending as, over time, more local governments get their economic houses in order. It may also be anticipated that the progressive decentralization reform along with the resulting authority of municipalities may also vest the municipalities with the responsibility for co-financing infrastructure projects, e.g. EU funded investment projects, and may thereby increase the demand for municipal credit by creditworthy municipalities.

On the supply-side, the unusually high liquidity in financial institutions promises an adequate supply of credit relative to effective municipal demand.

This conclusion assumes that reasonable macro-economic stability persists and that lenders become less cautious about accepting some risk in exchange for higher yields than they can earn on state guaranteed securities.

2.7. Institution Building.

The legal reform strategy must be embedded in a larger policy framework that further clarifies the roles of the public and private-sector entities that are engaged in the operation of a municipal credit market and the related requirements for their institutional development, including governmental and other regulatory institutions related to credit markets.

SECTION 3: LEGAL FRAMEWORK FOR MUNICIPAL CREDIT

3.1. Existing Municipal and Financial Sector Laws.

As discussed below, existing municipal and financial sector laws in Bulgaria do not comprehensively address the debt of general purpose local governments. Relevant rules are largely indirect, scattered among various laws and regulations or established on an informal basis. In several important instances they are incomplete or ambiguous. Complementing the proposals in the Government's Fiscal Decentralization Program, we strongly recommend a comprehensive and consolidated set of legal provisions to govern municipal borrowing, which could be enacted as a separate Act on Municipal Credit. This new law would amend existing legislation that impinges on municipal debt issuance such as the Law on Public Offerings of Securities, the Registered Pledges Act, and the Banking Act, as well as the Municipal Budgets Act and the Local Self-Government and Local Administration Act.

3.2. Recommendations for a Comprehensive and Consolidated Legal Framework for Municipal Credit.

The recommendations set forth below propose a more consistent set of rules to govern the issuance of municipal debt and to clarify the rights and obligations of borrowers and lenders over the life of any borrowing, most importantly in the event that problems with repayment arise. The objective is both to:

- To facilitate private, critical investment financing for those few municipalities that can now afford it, and

- To guard against highly imprudent municipal borrowing and other forms of abuse that can arise if municipal credit is not properly regulated.

As municipal borrowing grows, well conceived regulation is needed to protect:

- The interests of citizens within the borrower community itself (and the related national interest in maintaining financially solvent government throughout the country); and

- Individual investors (particularly those who are relatively unsophisticated) who may directly or indirectly have his savings invested in municipal securities.

Moreover, proper regulation can help avoid the type of major loan default or official impropriety (and the attendant bad publicity) that could seriously set back orderly municipal credit market development.

SECTION 4: ELEMENTS OF A COMPREHENSIVE LAW ON MUNICIPAL CREDIT

This section addresses each of the recommended elements for inclusion in a comprehensive law on municipal credit under the following headings:

Municipal Authority to Borrow
Purpose of Borrowing
Restrictions on the Issuance of Municipal Debt
Guaranties
Characteristics of Municipal Debt (Terms; Collateral)
Disclosure
Prudential Investment of Proceeds
Lender Remedies in Event of Default
Central Government Approval, Monitoring and Intervention
Joint Associations
Municipal Insolvency

The above elements can be found in laws regarding municipal credit throughout the world. They have been chosen based upon comparative, international experience in terms both of positive results from well-conceived enabling legislation and of lessons learned from problems encountered which might have been avoided by more careful attention to the legal framework at the outset of credit market development.

It is also important to note that the development of a legal and regulatory framework for a municipal credit market is not a product that remains set in place and static over time. Bulgaria's credit market will develop based on its own experiences, both good and bad, and the legal environment must be sufficiently flexible to adjust as the market grows.

4.1. Municipal Authority to Borrow.

The present legal framework sets forth a clear, simple, and reasonable procedure for authorizing municipal debt at the local level. Municipalities in Bulgaria have the general power to borrow under *40(1)* of the *Municipal Budgets Act 1998*. In addition, *52(4)* of the *Local Self-Government and Local Administration Act 1991*, as amended, gives each municipality the right to issue bonds. *21(10)* of this Act delegates decision-making authority in respect to bank loans and the issuance of municipal bonds to the municipal council.[6] The

[6] Municipalities may also receive loans from the State Budget and from other municipalities. *38 of the Municipal Budgets Act* permits short-term interest-loans from the State Budget to be extended to municipalities in exceptional cases, based upon a procedure and within time limits set by the Minister of Finance. *41* of that Act permits municipalities, based upon municipal council resolutions, to conclude contracts between themselves for the extension and use of loans under terms established by

Municipal Budgets Act similarly affirms that a resolution of the municipal council provides sufficient authorization to effect lawful transactions with banks and other financial institutions. (*40(1)*). No other action or approval is required.

However, there are several ancillary issues in respect to municipal debt authorization that the proposed legislation might address.

- *Present law prohibits a municipal council, within six months before the expiration of its term of office, from* passing a resolution to contract a bank loan, issue a municipal bond or extend short-term interest-free loans from the municipal budget. *(Municipal Budgets Act, 40(4)).* Here the intent is to prevent the issuance of debt for politically popular projects that may have the effect of influencing the electorate, but more importantly, to prevent the current legislative body from encumbering the municipality with excessive debt that will be binding on the succeeding municipal council. In the near term, given the limited volume of municipal borrowing activity, this mandated six-month moratorium has little practical consequence. However, as the municipal credit market develops and grows, it could prove disruptive to the "flow of deals" and secondary market supply. Also, this timing limitation could unnecessarily preclude a local government obtaining access to commercial financing during a window of advantageous market rates.

- Longer term municipal lending is inhibited by the capital market concern as to whether subsequent municipal administrations will honor debt commitments made by their predecessors*.* Interviews conducted for this study reveal a reluctance on the part of some lenders to consider approving a municipal loan for a maturity that extends beyond the term of the present municipal council. This reluctance largely reflects uncertainty as to the political commitment of a succeeding legislative body to honor financial obligations incurred by its predecessor. Some lenders appear to believe that there is actually a legal prohibition against municipal loans that extend beyond the present council's tenure, but the problem appears to be one of market perception rather than law.

The Philippines: How Fear of Political Risks Can Inhibit Municipal Credit Markets

In the Philippine city of Cebu, a newly elected mayor made statements that questioned whether his administration would be bound to honor a debt incurred by the prior council. Ultimately, he withdrew the statements and the City paid the debt on time. However, this incident scared the financial community, and, in effect, has caused lenders to limit loan and bond maturities for local governments In the Philippines to the current administration's term of office. In order to counter this maturity limitation, some Philippine local government administrations have held voluntary referenda of the voters to demonstrate popular support for specific project debt financing and thereby overcome financial institution fears of the political risks associated with long-term lending.

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that Act. This provision is consistent with *137* of the *1991 Constitution,* that states that municipalities shall be free to associate in the solution of common matters, based on conditions set by law.

Additionally, there is the issue of which municipal entities may issue debt. At the present time there are a limited number of "creditworthy" municipalities that could access capital. Although a reasonable argument can be made that "market forces", i.e. the lending community, is the appropriate stakeholder to make such credit determinations, consideration should be given to creating a "levels of authority". For example, municipalities below a certain population size may be prohibited from borrowing; an intermediate level of municipality may be permitted to borrow, however, some ""extra approval" might be required; and a level established for potentially more creditworthy municipalities would only be required to provide notification to some central registry of the issuance of debt.

Issues related to joint financing by municipalities are discussed separately below.

4.1.1 Recommendations. Capital market confidence in the binding nature of a financial obligation on succeeding legislative bodies is an essential precondition for enlarging the availability of long term debt financing for municipal investment. This principle should be explicitly affirmed in any municipal credit legislation. The law itself should recite the binding nature of municipal obligation to repay debt that has been duly authorized.

Example of language on the binding nature of financial obligations

France, Code Général des Collectivités Territoriales

L.1612-15 –The only obligatory expenditures of local authorities are expenditures necessary to pay debts that come due, and expenditures, which have been expressly determined by law.

Romania, Local Public Finance Law, 1998

48. - (1) Local and judet councils, and the General Council of the Municipality of Bucharest, respectively, can approve the contracting of internal or external loans, for a long or a medium term, for public investments of local interest, as well as for re-financing the public debt, under the provisions of this Section.

(2) Local and judet Councils, and the General Council of the Municipality of Bucharest may decide upon contracting loans by the vote of at least two thirds of their members.

(3) The local public debt incurred under the provisions of paragraph (1) represents a general obligation which needs to be reimbursed, according to the agreements concluded, from the sources available to the territorial administrative unit, with the exception of special purpose transfers from the state budget.

Additionally, as noted above there may be many cases in which a six-month delay in financing will be disadvantageous to both project costs and market opportunities.

Central Government Approval:

Notwithstanding the above described moral hazards of central government approval of municipal borrowing, the lack of prudent borrowing precedent, and an uncertain legal environment, suggests that some form of limited approval as to legal validity or other review might be considered at the early stages of municipal borrowing. However, it is more likely to be beneficial to establish an objective standard for a debt limitation, and limit any central government approval to certain types of financing that may justify more scrutiny, e.g.

- debt issued in a foreign currency;[7]
- debt issued to refinance existing debt;
- debt issued by municipalities that have defaulted on debt within X years;
- debt that is secured with an intercept of funds transferred from the central government to the municipality[8]; or
- authorize a municipality to exceed its debt limit in certain limited circumstances, such as:
    1. the municipality has a higher degree of creditworthiness, or has received a credit rating;
    2. the projects to be built will clearly increase l revenues in future years or are self-financing;
    3. the projects to be built will reduce expenditures in future years; or
    4. the projects to be constructed have the potential to attract grant co-funding from the private sector or foreign assistance programs (e.g. EU pre-accession funds).

The criteria for such approval are best left to regulations to be adopted that will have the flexibility needed to deal with the circumstances of a developing market.

The Central Government could require, as a condition to the issuance of debt by a municipality, that it receive prior notice of such issuance with such information that would be helpful in maintaining a national registry of municipal debt. An approval of municipal debt could be limited to the verification of the debt limit calculation, an objective standard that could avoid many of the moral hazards related to a more subjective approval of debt. Such a limited approval could give the lending community some degree of comfort without subjecting the municipal to the more political and subjective process of debt approval.

[7] The Romanian Law on Local Public Finance requires that a specially created Government Debt Commission (composed of representatives of the national bank, municipalities and the Ministry of Finance.) approve all debt issued in a foreign currency.

[8] This would also function as an acknowledgment of the lender's security interest in the transferred funds.

The options for the role of the central government could range as set forth below and could be different for short-term and long-term Debt: E.g.,

1. *no approval, only an acknowledgement of the Notice, after the issuance of Debt;*
2. *no approval, but a limited right to “object” within XX days to the calculation of the compliance with the debt limitation prior to the issuance of Debt;*
3. *approval of only the debt limitation compliance calculation within XX days; if approval is not received within XX days, the issuance is “deemed” approved;*
4. *express approval of any Debt that is issued:*
    a. *to refinance existing Debt;*
    b. *by a Municipality that has defaulted on Debt within the past X years;*
    c. *in a foreign currency;*
    d. *secured with an “intercept” of funds between the central government and the Municipality; or*
    e. *to exceed the debt limitation in circumstances, such as:*
        - *the Municipality has a higher degree of creditworthiness, or has received a minimum credit rating;*
        - *the project to be built will increase revenues in future years or are self-financing; or*
5. *the project to be built will decrease expenditures in future years.*
6. *express approval of ALL Municipal Debt.*

4.2. Purpose of Borrowing.

While present law does not provide a clear, consolidated statement on the authorized purposes of municipal borrowing, it does contain several provisions that serve to define the scope of a municipality’s authority to incur debt:

- **No Borrowing to Meet General Expenses***. Section 52(5) of the Local Self-Government and Local Administration Act* prohibits a municipality from contracting a credit to defray general expenses, including wages and salaries.

- **Financing of Authorized Budget Deficit**. Section *10(1) of the Municipal Budgets Act* permits a municipality to plan an annual budget deficit up to 10 percent of total projected revenues. Based upon a municipal council resolution, that authorized budget deficit may be financed through issuance of securities (i.e. municipal bond issues),[9] loans from financial institutions, and from off-budget revenues and other sources. (10, Sections (2) and (3)).

[9] 10(3) of the Municipal Budgets Act requires that the issuance of bonds must conform with procedures set forth under the *Securities, Stock Exchanges and Investment Companies Act 1995.* This should now be interpreted to refer to the new *Law on Public Offerings of Securities* of January 200, as amended.

- **Financing of Temporary Deficiencies**. Section *24 of the Municipal Budgets Act* permits a municipality to borrow from banks and other financial institutions, as well as from other municipalities, the State Budget (as set by the Minister of Finance), and from certain municipal off-budget resources and funds, in order to meet temporary deficiencies within a given budget year. 24 originally provided that such borrowing shall not exceed 10 percent of total municipal revenues (as set under 6 of the Act. However, the Constitutional Court abolished this provision as being in conflict with the constitutional principle of local self-governance.

- **Financing of Municipal Investments.** The permanent laws that govern municipal budgets and finance contain no explicit reference to borrowing for the purpose of long-term investment in facilities and infrastructure. To find any explicit authorization of local debt for investment purposes, one must turn to the succession of annual State Budget Acts which provide that expenditures might be made from municipal budgets for the “acquisition of long term assets” from own source revenues and bank credits.” This annual authorization is subject to fairly strict limits, which are discussed in the next section under the heading “Restrictions on the Issuance of Municipal Debt”.

4.2.1 Recommendations. Provide that short-term financing, which shall be paid within the budget year, may be used to finance cash flow budget deficits, and that financing which extends beyond the current budget year may be issued solely for capital investment or refinancing of debt issued for capital investment that serves a "public purpose" authorized in the municipal budget.

Rationale for the Above Recommendation*:* As noted, present law contains no guidance or limit on the specific uses of long term debt that are viewed as valid. In particular, the law should distinguish between debt, which is issued for a "public" purpose and that which is issued for a publicly-owned, but inherently, private entrepreneurial activity. A number of Bulgarian municipalities remain engaged in the ownership and operation of varied private entrepreneurial businesses (e.g. bakeries; hotels), at least indirectly through municipally owned enterprises (MOCs). Perhaps the municipal credit law, in defining “public purpose”, should clearly preclude debt incurred for the benefit of such private entrepreneurial activities, or municipal guarantee of such debt. In other words, the municipal government could borrow on behalf of a municipally owned garbage company, but not to benefit a municipal bakery. An MOC (such as a bakery) that competes more directly with private firms should have to finance loans for its investments solely from the pledge of its own revenues and assets—not from the municipal treasury. The public purpose clause in the municipal debt law should contain an explicit prohibition against the use of the municipal borrowing authority solely or primarily to benefit a private party (property owner and or business).

4.3. Restrictions on the Issuance of Municipal Debt.

Central governments have a legitimate concern that municipal governments don't take on an excessive amount of debt in relation to their financial resources. Most countries try to accomplish this, in part, through some form of debt limit—typically in the form of:

- A limit on the aggregate amount of indebtedness a given municipality can incur, and/or

- A limit on the amount of annual debt service (interest and principal repayment) it can assume relative to some measure of available revenues to service this debt.

Current Bulgarian law does not contain an explicit limit on municipal debt as defined above. However, it does contain two other limits that in the minds of market participants are sometimes confused with a debt limit:

- As noted in the previous section, the *Municipal Budgets Act* permits an authorized deficit of up to 10 percent of planned revenues *(10 (1))* which may be financed by issues of bonds, loans and off-budget resources. *(10 (2))*. However, this is *not* a debt limit, but rather a permitted means of financing a limited deficit.

- The annual State Budget Acts each restricts the funding of municipal investments to a set percentage of own source revenues. Thus *14 (3)* of both the 1998 and 1999 *State Budget Acts* provides that expenditures might be made from municipal budgets for the "acquisition of long term assets" from own source revenues and bank credits only up to 10 percent of its annual own source revenues. Municipal bond issues were not specifically mentioned as a possible source. *14 (4)* then states that if that limit is exceeded, then the subsidy from the State budget to that municipality shall be reduced by the excess amount. The *2000 State Budget Act (12 (2)*) reduces the 10 percent ceiling on local investment to five percent of own source revenues, the 2001 State Budget Act contained no such limitation, and the 2002 State Budget Act limits investment spending on the acquisition of long-term assets up to 25% of local taxes and non-tax revenues, a severe limitation on local discretion to finance infrastructure and other capital needs. The structure of the recent Sofia Eurobond caused the meaning of this limitation to be clarified by an interpretation of the national Audit Office. Based upon that opinion, the size of the bond issue did not violate the 10 percent deficit limitation. However, to comply with the State Budget Act limitation on investment expenditures, Sofia's use of the proceeds to fund specific capital projects had to be spread over several budget years.

4.3.1 Recommendations. There should be a debt service limitation provision; and the Government should terminate the practice of including an investment limit in the annual State Budget Acts.

Both these recommendations are detailed and elaborated below, including preferable alternatives for achieving the objectives underlying the current investment limit.

Debt Limit. As noted above, a debt limit provision is recommended both as a means to preclude irresponsible borrowing and to constrain aggregate municipal indebtedness.

Although the debt of the Bulgarian public sector (defined as sovereign debt and sub-sovereign debt) has been declining as a ratio of GDP, the debt ratio remains higher than the 60 percent limit established by the European Union for public sector debt. For this reason and for general reasons of prudent borrowing for municipalities which are severely restricted in their ability to generate their own source revenues, debt limitations may give comfort to both the central government and the lending community. Thus the following limitations are recommended for consideration:

a. Short-Term Debt

Only short-term debt shall be issued for the purpose of the temporary financing of a cash flow deficit in an amount not to exceed (5 percent, perhaps as high as 10 percent) of total budgetary revenues, provided that such debt is repaid within the current budget year. Romania now has such a limitation of 5 percent of such revenues. (See box below).

Examples of language on short-term debt

Republic of Latvia, Law on Municipal Budgets, 1995

23 – For the purpose of the budget and finance management in order to cover a short-term fiscal deficit, the municipalities shall be entitled to take short-term loans. The municipalities shall repay borrowings from the state budget by the end of the current economic year.

24 – For the purpose of economic and social program implementation, the municipalities are entitled to take long-term loans. Such borrowed funds must not be used for the financing of permanent (current) functions of the municipalities.

Hungary, Act on Local Government, 1990

88(7) – For the purposes of this Section, liquid credit is the credit raised and repaid within one year, for the purpose of the continuous operation of public service and state administration duties.

Romania, Local Public Finance Law, 1998

53. - (1) In case during the execution temporary cash deficits are registered, as a result of the gap between the revenues and the expenditures of the local budget, the former can be covered through loans granted from the available funds in the general account of the state treasury, provided the revolving fund has been used.

(2) The total amount of the loan which can be engaged by local public authorities according to the provisions under paragraph (1) is subject to the following limits:
1) It shall not represent more than 5% of the total revenues which the territorial administrative unit estimates to collect during the fiscal year in which the loan is engaged;
2) According to the provisions under paragraph (2), point 1), local public authorities cannot engage loans which are larger than the funds which it can reimburse during the same fiscal year.

Republic of Lithuania, Decree on Usage of Bank Credits by Local Authorities, 1998

2 - The following limits on borrowing by municipalities are set:
2.2 The annual borrowing limit of a municipality is 10 percent, including a short-term borrowing annual limit of 5 percent, of the approved revenues of that year (excluding grants for special purposes to the municipality from the State Budget of the Republic of Lithuania).
3 – Total debt of a municipality includes short-term (up to 1 year) and long-term (1 year and more) debts of all sources of borrowing.
13 – Municipalities can take long-term loans for the financing of investment projects only. Municipalities can take short-term loans in the course of the year for the purpose of covering a temporal shortage of funds.

b. Long-Term Debt

Set forth below is a proposal for a debt limitation for consideration:

Long-term debt shall be issued solely for the purpose of financing long-term "public purpose" investments (and the refinancing thereof [consider a refinancing test of demonstrating "debt service savings" or some form of "approval"]) with a maturity not to exceed the useful life of the facilities being financed; provided that, the annual debt service on all of a municipalities' outstanding debt, [in any future year (calculated at the time of issuance of the debt) shall not exceed [XX] percent; of its annual "total current revenues" for the year in which the debt is issued (or the prior year for more "verifiable" revenues). (Total current revenues should be defined to carefully exclude any one time (non-recurring) revenues such as proceeds from major privatization sales and targeted state transfers. The test should be based on "recurring revenues over which the city has discretion to determine how the funds are spent"; one-time revenues and transfers designated for specific purposes and not available to pay debt should be excluded from any formula).

Compliance with the limitation shall be determined at the time of issuance of the debt. In order to make such calculation:

(i) Any debt bearing interest at a variable rate shall be calculated at the rate in effect at the time the debt is issued or based on an independent formula in effect on the date of issuance and applicable through the term of the debt; additionally debt payable in an external currency shall be calculated at the exchange rate at the time of calculation.

(ii) The debt service shall be structured so that annual payments are not less than the amount that would be provided if the payments were calculated to be substantially level annual amounts over the term of the credit, thus preventing deferred balloon principal payments, or other dangerous deferrals of principal repayment[10].

(iii) The portion of any debt service that is secured solely by a dedicated revenue source, i.e. a project revenue financing, and is not payable from the general treasury of the municipality, shall be deducted from the aggregate debt service calculation, and the dedicated revenue shall be deducted from the available revenue total.[11]

(iv) The portion of any debt service shall be deducted from the calculation if there shall be irrevocably set aside sufficient funds, that invested in Government Securities will mature and bear interest in an amount sufficient to pay such debt service when due. This would permit the exclusion of any “refinanced” debt for which an irrevocable escrow has been created to provide for its payment. It would also permit the deduction of any debt service for which a “reserve fund” has been created.

It should be noted that in some countries, debt that is secured by “physical collateral” is not counted towards the debt limitation.

The debt limitation might initially be set as low as [X] percent of current revenues, but should be reconsidered periodically as progress is made in law and practice in strengthening municipal finances. Over a period of time, the debt limit might be raised to as high as [X+Y] percent. The actual percentage of the limitation may be an appropriate provision for a Regulation that could provide more flexibility to reflect changing circumstances.

Additionally, consideration should be given to permitting that some central authority, e.g., the Ministry of Finance, be given the discretion to review and approve a Municipality’s request to exceed the debt limit provided that it can demonstrate that its own local revenue base can support such greater amount of debt. Such a procedure for exception would allow:

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[10] It should be noted that the EBRD is presently structuring its loans with level principal payments, resulting in a decreasing debt service schedule. The level debt service requirement does not need to be stated in the law as the debt test will be an incentive for at least level debt service.

[11] This would permit “enterprise” debt that is not an obligation of the municipality to be “outside” the debt limitation. Such a distinction may be too aggressive in the initial stages of a municipal credit market.

(i) additional financing for more creditworthy municipalities[12], and
(ii) financing of investments that have a positive net impact on cash flow either by the generation of increased revenues or decreasing operating expenses, e.g. utility and energy conservation projects.

A debt limit, which restricts debt service to a percentage of budgeted revenues, has been used in other transitional economies (see the Table below). Examples of such limits presently in effect include:

Latvia:

(i) A special borrowing council approves specific municipal projects financed by loans. As a basic rule 20% of local own and shared sources should cover the debt service;
(ii) Municipalities may not borrow for expenses;
(iii) The limit of local government borrowing is set by the annual budget; and
(iv) If there has been a prior default the Ministry of Finance must approve the debt.

Hungary:

The debt limit (debt service including guarantees) calculates debt service
(on debt and guarantees as a percentage of total own source revenues

Poland:

(i) annual debt service shall not exceed 15 percent of budgeted revenues, and debt carried beyond the current year may not be greater than 60 percent of budgeted revenues.[13]

(ii) the limit is further decreased as the total public debt approaches the EU's criteria that "total public sector debt[14]" shall not exceed 60% of GDP, i.e., by declining to 12% of revenues when the public sector debt is at 55% and the prohibition of municipal borrowing at 60%.

Czech: No limit on the amount of debt.

EU: The EU criteria on public sector debt (60% of GDP) includes State and local government debt but excludes debt of local government "commercial enterprises."

[12] Such creditworthiness could be demonstrated by requiring such municipalities to obtain an independent credit rating as a condition to obtaining such an exception.

[13] *Law on Public Finances 1998,* Sections 113 and 114.

[14] includes sovereign and subsovereign.

Romania: Annual debt service shall not exceed 20 percent of total current revenues, including the shared wage tax.[15]

4.3.2 Alternatives to the Present Investment Limit. Based on comparative international experience, investment limits send an inappropriate message to local governments and are a clumsy means for dealing with legitimate MoF concerns about municipal budgeting practices. Municipalities that generate a surplus from their operating budgets, should be encouraged, rather than prevented from using funds for municipal capital investments. In our interviews, we heard three types of arguments made to explain the necessity of preserving these limits. These arguments, and the recommended alternative for addressing the underlying concern, are as follows.

Argument #1: Many Bulgarian municipal governments are not budgeting adequately to operate essential services such as schools and medical clinics. Under these circumstances, local governments shouldn't be diverting funds to lower priority (and in some instances, relatively trivial) investments.

Response. If the concern is inappropriate municipal priorities, then the Local Self-Government and Local Administration Act in Section Two should be amended to specifically establish the priorities and obligatory mandates the government deems essential. This would put municipal governments on notice that these priority public service responsibilities must be met before funding other operations and investments. It should be noted that the annual State Budget Acts do set municipal budget priorities for the given year. (See Sections 14(2) and 13(3) of the 1999 State Budget Act and Sections 12(1) and 11(3) of the proposed 2000 Budget Act.) Under the 2001 and 2002 State Budget Acts, funding priorities are being defined by the municipal councils (excluding action funds). However, embodying the fundamental priorities in permanent legislation would add to the force and clarity of these imperatives.

Argument # 2. The "investment limit" is needed to head off excessive municipal deficits and indebtedness that can threaten central government efforts to preserve macro-economic stability, comply with IMF conditions, and continue progress in deficit reduction towards EU norms.

Response. If the concern is municipal deficits, this is more forthrightly addressed by a hard budget constraint that prohibits carrying forward unpaid operating liabilities into the next budget year, or makes such liabilities the first priority, municipal payment obligation in the subsequent year.

If the concern is excessive municipal indebtedness, the appropriate regulation is the type of debt service limitation proposed above, rather than an investment limit.

[15] *Law on Local Public Finance 1998, 51).*

Table IV.1: Municipal Debt Limitations in Selected Countries

Country	Debt Service Ratio Limit	Debt "Revenue" Limit	Other Restrictions
A. Central and Eastern Europe			
Poland	15 percent of total revenue (debt service includes potential liability under guarantee commitments).	None.	• Short-term loans must be repaid within fiscal year; • No State guarantee, unless explicitly stated; • Long-term credit only for investment. • Carry-forward of unpaid principal on all debt to next budget year cannot exceed 60 percent of budgeted revenues
Hungary	70 percent of own current revenues (local taxes, fees, interest revenues, environmental fines). Debt service includes potential liability under guarantee commitments.	None.	• Local governments with outstanding loans and expenses of more than 100 million HUF must have external independent audits; • Loans cannot be secured with primary assets, general transfers from the state, shared personal income tax; • Debt-service restriction does not apply to short-term liquidity loans.
Romania	20 percent of current revenues	None.	• No State guarantee; debt registration documents must include a clause to this effect; • Debt incurred must be reported in the public debt register and reported annually; • Short-term cash balance loans limited to 5 percent of total revenues; • External borrowing must be approved by a Loan authorization commission
Lithuania	10 percent of total revenue, excluding earmarked grants.	Borrowing cannot exceed 10 percent of total "revenue" in approved budget (excluding earmarked grants); there is a	• Debt stock is limited to 20 percent (30 percent for Vilnius) of total revenue; • Short-term loans must be repaid within fiscal year; • No State guarantees; • Ministry of Finance can impose lower borrowing

Country	Debt Service Ratio Limit	Debt "Revenue" Limit	Other Restrictions
		sub-limit of 5 percent for short-term borrowing.	impose lower borrowing ceiling for individual municipalities based on budget performance; • Long-term credit can be used only for investment and must be approved by a Loan Commission of the MoF.
B. Other regions of the world			
India	None.	None.	• No borrowing in foreign currency; • Long-term credit only for investment; • Need case-by-case approval of State government for municipal loans or bonds.
Columbia	Debt service limit is 30 percent of recurring revenue as long as debt service is also less than 40 percent of operating surplus. When debt service exceeds 40 percent of operating surplus, municipalities are subject to a variety of fiscal controls.	None.	• Temporary imposition of 1.5 risk weighting on municipal loans for capital adequacy calculation; • Collateral requirement can be up to 150 percent of loan value; • A limit is placed on the stock of outstanding debt relative to recurring revenue.

4.4. Municipal Guarantees.

A guaranty is a financial obligation that is contingent solely on the nonpayment by the guaranteed party. Upon such nonpayment, the guaranteed debt becomes the debt of the guarantor, i.e., the municipality. The issuance of guaranties should not provide an opportunity for a municipality to do indirectly what it cannot do directly through the issuance of debt.

The present legal framework does not contain provisions relating to guarantees.

4.4.1 Recommendations. The authorization procedures and purposes of municipal guarantees should be the same as for municipal debt. The guaranty mechanism should not provide a method to incur debt indirectly in a manner and for a purpose for which debt could not be directly issued. Consider limiting the entity that may have its debt guaranteed to a legal entity that is “controlled” by the municipality.[16] In many developing municipal credit markets, municipal guaranties of municipal owned utility enterprises are a common financing device; therefore it is of substantial importance that the issuance of guaranties by municipalities be accomplished within a legal framework that clearly authorizes its purposes and limitations.

Municipal guarantees of third party debt should be:

- *authorized in the same manner as municipal debt;*
- *for projects for which municipal debt could be issued (i.e., “public purpose”);*
- *limited to third parties that are either created or controlled by the municipality; and*
- *should be counted towards the debt limitation in the same manner as direct debt, or some lesser percentage thereof for such time as the municipality has not paid on the guarantee.*

Some examples of comparable international standards are as follows:

<u>Latvia:</u> A local government cannot guarantee the debt unless it owns at least 50% of the borrower. (or an association that is at least 65% government owned)

Poland and Romania require that 100% of the guaranteed debt be allocated towards the municipality’s debt limits; and

Another possibility is to allocate a percentage of the guaranteed debt to the applicable municipal debt limit until such time that a payment is made on the guaranty and then to allocate 100% while payments are being made on the

[16] This may result in a municipality being required to have at least a “majority interest” in such an entity.

guaranty and for a period of time thereafter. The percentage could be based on some determination of the creditworthiness of the guaranteed party.[17] This is the recommendation that is made for consideration in the debt limit formula discussed above.

4.5. Characteristics of Debt.

4.5.1 Terms of Debt. As mentioned above, municipal councils are authorized by law to approve borrowing. However, the legal framework provides virtually no rules on the permissible terms (maturity of limitation, interest rate, method of restructuring debt repayment) of any given borrowing that a municipal council may decide to authorize. Other than the requirement of 24(3) of the Municipal Budgets Act that temporary financing be repaid within the current budget year, Bulgarian law contains no restrictions on:

(i) The length of maturity for long-term debt. However, as discussed above, the unwillingness of the lending community to extend a maturity beyond the term of office of the existing municipal government has established a de facto maturity limitation, at least for bank lending;
(ii) The method of interest rate calculation, i.e., variable rate or fixed rate; and
(iii) The method of structuring debt repayment, i.e., level principal payments, level debt service payments, or level interest payments.

Pursuant to the Foreign Exchange Act it appears that debt denominated in a foreign currency would need to be registered at the Bulgarian National Bank.

4.5.2 Recommendations. There should be legal authority providing that:

- Short-term debt for cash-flow deficit financing be repaid within the current budget year;

- Long-term debt shall have a maturity not longer than the useful life of the assets acquired with the proceeds of the borrowing. (this provision would be especially important with regard to the issuance of revenue bonds.);

- Debt may bear interest at either a fixed or variable rate; provided, however, that any variable rate shall establish a maximum limit (note: this maximum limit may create a resistance barrier for lenders and may not be practicable at the beginning or result in the establishment of very high maximum limits. Although it is a prudent idea, it may be counterproductive if it will prevent lending altogether); and

- Debt may be denominated in a foreign currency only with the prior approval of the ministry of finance (or other central government authority).

[17] Creating such credit distinctions may be a too sophisticated process in a new municipal market.

As a rule, municipalities should be discouraged from assuming foreign currency risk. Sofia's 1994 (dollar denominated) loan to fund buses purchases illustrates the dangers involved. At one point the city witnessed the exchange rate rise to over 3000 BGL to the dollar from a starting point below thirty.

4.5.3 Tax Status. Tax laws have a powerful effect on the development of municipal credit markets and motivation for different categories of lenders and investors to participate in such markets.

In Bulgaria, *12(1)(3)* of the *Taxation of the Income of Natural Persons Act 1997*, effective January 1, 1998, as amended, provides that interest paid on State securities and municipal securities is not liable to tax when such securities are acquired by natural persons.[18]

By contrast, the Corporate Income Tax (which applies to any interest income earned by "legal entities" does not contain any such tax exemption.

In thinking about the tax status of municipal debt, some distinctions in the overall tax status of different classes of capital market participants is worth keeping in mind:

- The tax status of pension funds will be governed by two recent laws which both took effect on January 1, 2000: *The Obligatory Social Insurance Code* and the *Additional Voluntary Pension Insurance Act*. Under the first of these laws [*160 (1) and (2)*] the incomes of universal and professional pension funds are exempt from the *Corporate Income Taxation Act* and incomes earned on the assets in the accounts of secured persons are exempt from the *Taxation of the Income of Natural Persons Act*. The second law [*s 92 (1) and (2)*] contains parallel provisions for the voluntary pension funds.

- Commercial banks and insurance companies would pay taxes on interest income earned on municipal securities on the same basis as would any other legal entity;

4.5.4 Recommendations. Most economists argue against tax exemptions for any form of public securities on the grounds that such exemptions distort the efficient market allocation of capital among sectors and between the public and private sectors. Notwithstanding, such tax exemptions are common to many countries in both the developed and transitional worlds. The important

[18] Additional Provisions #11 of the Act defines "interest" as "income from any debt claim, regardless of whether it has been secured through a mortgage or by a clause envisaging a stake in the debtor's profit, as well as income from bonds, debentures and other financial instruments related to these securities."

point for a municipal credit market is that as long as interest on government securities remains exempt, then municipal borrowing should be exempt as well.

We recommend that the current exemption be preserved at least for the period during which the municipal credit market is being established, given (i) that the tax exemption is already in place; (ii) that the small amount of municipal debt likely to be issued over the near term does not threaten the State Treasury with any material loss of income tax revenue from the exemption; and (iii) the possible attraction of this feature to potential investors, particularly the pension funds. The municipal credit law should reconfirm and make this tax exemption more explicitly to eliminate any uncertainty in the eyes of prospective municipal bond purchasers.

Arguments for and against continuing the municipal bond tax exemption should be reviewed if and when the volume of municipal lending becomes significant. Such a review should reconsider tax exemption with regard to all government securities, not just municipal securities, so that municipal securities are not given second-class treatment.

Similarly, if in the future the Government should decide to grant legal entities a tax exemption on income from State securities (similar to the exemption now enjoyed by Natural Persons), then this enlargement of the tax exemption should explicitly include municipal utilities as well.

Additionally, in order to promote competition among various financial instruments, any tax exemption for the interest on municipal debt should not "favor" one form of debt over another and all instruments should be treated equally.

4.5.5 Collateral. Current Bulgarian law and practice in respect to securing municipal debt poses several problems for the development of a municipal credit market:

- Unlike private sector borrowers, municipalities and their lenders have no legally authorized procedure for perfecting pledges under the Particular Ledges Act, which allows a pledge to be established by means of a registration in a special register, but without transferring possession of the asset to the creditor;
- There is excessive reliance on physical collateral to secure municipal debt;
- There is no clear legal authority to pledge future municipal revenue streams to secure a loan or for intercepts of central government transfers—in lieu of or in addition to pledges of physical collateral.

Registering Municipal Pledges. The *Special Pledges Act, as amended (Section 3),* does not authorize a municipality to register a pledge on behalf of its creditors except in very limited circumstances, e.g., the pledge of "paperless" securities. Since municipalities are not merchants under the *Act* (see *Section 3*), their pledges may not be recorded in the pledge's record at the Central Pledges Registry or other designated registry under that *Act*. Such registration allows the creditor to "perfect" his lien rights relative to those of third parties. (*Section 12* of that *Act*). This omission poses two difficulties for lenders contemplating loans to municipalities:

- Most fundamentally, the lack of a procedure for registering pledges (regardless of the form of security involved) adds to the lenders perception of uncertainty and risk should he ever have to rely on enforcement of the pledge to ensure repayment;

- Furthermore, access to the established registry for pledges would reduce the chance that a municipality might pledge the same security to two different lenders—a problem that has arisen in other countries. Pledge registration greatly simplifies the due diligence a prudent lender must undertake to guard against this risk.

The Form of Collateral*.* The reasons why pledges of future revenue (as opposed to pledges of municipal property) should be viewed as the preferred means to secure municipal debt is discussed above. The Municipal Budgets Act requires that loans to municipalities be "secured by a mortgage and/or pledge of municipal property", and prohibits the payment of municipal debts out of resources allocated from the State budget. A mortgage can be established only with regard to real property. Municipalities can pledge movable properties or private (generally, non-tax) receivables, but as noted above without the benefit of the Particular Pledges Act. (40, sections (2) and (3)). (Note: This provision does not explicitly apply to municipal bonds.)

Further, the *Municipal Property Act 1996, as amended,* makes a useful distinction between "municipal public property" and "municipal private property". (*Section 3(1))*.[19] Only municipal private property can be used to secure debt. Public municipal property may not be encumbered for the benefit of creditors under *Section 7(3)* of that Act. Section 7(3) of that Act specifically permits municipal private property to be so encumbered. However, it is possible for municipal public property that has ceased to have its public uses under Section 3 to be declared municipal private property by a two-thirds vote of all of the members of the municipal council. Section (6).

[19] Section *3(2)* of the *Municipal Property Act 1996, as amended*, defines municipal public property as (1) real property assigned for the performance of functions of local government authorities and local administration, and (2) real property assigned for the longer-term meeting of public needs of municipal significance. All other municipal property, including the products and revenues of public municipal property, is municipal private property under Section *3(3)* of that Act.

This distinction in Bulgarian law between municipal public and private property makes good sense and should help avoid problems that other countries have encountered as their credit markets have begun to grow. These problems include both:

- The difficulty of valuing an asset committed to a long term and essential public use, and

- More critically, the legal, political, and equity issues that arise should a lender actually try to foreclose on such an asset.

Given the present legal constraints, virtually all of the commercial bank loans to date have been general obligations of the municipality secured by mortgages on the municipality's private property or pledges of shares in municipally owned companies. To date, the actual experience in structuring real estate collateral for municipal loans has been quite limited. The problems encountered have been attributable more to particular factual circumstances than to defects in the legal framework—for example, outstanding restitution claims or confusion in the allocation of ownership interests between the national and local agencies involved.

Ambiguities in Respect to Pledges of Future Revenues*.* At present, Bulgarian law contains ambiguities as to whether or not a general purpose local government could make a pledge of specific, future revenue source to secure either a loan or a “revenue bond, Although the *Municipal Budgets Act* does not explicitly prohibit the repayment of such debt from municipality own source revenues, it does not contain any explicit authorization. At a minimum, the law’s silence could raise uncertainty in a lender’s mind.

Moreover, *Section 7(2)* of the same *Act* states that municipal revenues, with the exception of ad hoc grants and subventions allocated from the State budget, are to be used to cover all expenditures. This suggests that revenues from a specific tax or fee may not be set aside in a special account or fund to secure a loan repayment. Also, the only reference to “bonds” in the Municipal Budgets Act is in 10 as a means to fund authorized budget deficits. This could suggest that the only authorized purpose of bond financing is to finance such deficits, and that such bonds must be general obligation (as opposed to revenue) bonds. Given these legal ambiguities, new legislation is needed to clearly permit the issuance of revenue bonds (As discussed below, this is not the case in respect to revenue bonds issued by MOCs, or bank lending secured by an MOC revenue pledge.)

Despite these legal uncertainties, it should be noted that there have been some recent municipal borrowings based on unsecured general obligations payable from municipal revenues and/or assets—the Gabrovo loan from DSK, and the Sofia Eurobond issue and the Svishtov bond issues.[20]

State Transfer Intercepts*.* Section II also recommended the concept of a State transfer intercept (if properly designed) as an attractive means to secure and enhance local credit without any State guarantee. At present, the Municipal Budget Act explicitly disallows debt repayment from resources allocated from the State budget. Clearly, specific legislation would be required to introduce the use of a broadly defined, State transfer intercept in Bulgaria.

The Question of Implied Guarantees*.* Present Bulgarian law does not contain any specific implication of a central government guarantee of municipal debt obligations, but, on the other hand, neither does it contain any explicit disclaimer. To date, this silence does not appear to have caused any confusion among market participants. Most lenders and investors appear fully aware that municipal obligations are limited in nature and do not carry an implied State guarantee.

4.5.6 Recommendations. *The Special Pledges Act* should be amended to expressly permit municipalities to register the pledges made to creditors, with that *Act* referenced in an in the *Law on Municipal Credit* itself. This change is critical regardless of what forms of security are permitted. Creditors must have confidence that they can enforce their rights in the event of a loan default.

- Government policy should encourage local governments and lenders to look to pledges of future revenues to secure municipal debt, rather than to rely on pledges of real estate or other property assets.

With this objective in mind, the municipal credit law should permit local governments:

(1) To secure debt with a pledge of the collected shared taxes and own source revenues (including off-budget revenue sources as well) that are set aside in a separate account for the benefit of the lender;

[20] As noted above, the Svishtov bond issue is secured only with a general pledge on municipality assets and by the municipality's general obligation. However, according to interviews with Unity Invest, the bond's financial advisers, the City has initially proposed offering municipal property as collateral. They report that SSEC raised the questioned whether such collateral could be used, in part on the grounds that each individual bondholder should be able to identify what he would claim against individually. In the end, the municipality and the SSEC agreed that the collateral of the bond issue includes all of the assets of the municipality. Thus everyone who owns a bond could get a writ of execution that put the accounts of the municipality under restriction.
Section 237(g) of the Code on Civil Procedure (added in 1997) states that agreements concerning stipulated obligations to pay pecuniary amounts are subject to compulsory execution. This provision would cover interest payments on municipal bonds because the issuance of such bonds was approved by a municipal council decision. Yet there is no experience with enforcing such a claim and the question of priority relative to other creditors has never been addressed or settled in the courts.

(2) In connection with the above recommendation, to establish separate accounts on funds for segregating specific revenue sources dedicated to repaying specific credits.

- The Law on Municipal Credit should authorize local governments:

(1) On a voluntary basis, to enter agreements to provide for intercepts of these revenue sources when collected and transferred to them by the central government; and
(2) With the express approval of the MoF, to pledge and authorize the intercept of central government subsidies as State aid intercepts.

Drafting of any intercept provision should proceed with great care. Intercepts are a proven and potent tool to help accelerate credit market growth, but they are also subject to abuse. Local governments get in the habit of relying on the intercept rather than maintaining the discipline of making timely debt payments on their own. And if the intercept law is too permissive, an ambitious mayor and council can tie up a disproportionate portion of a local government's main revenue sources for years to come.

In some countries, a different class of problems has arisen where the ministry of finance and private lenders cooperate too closely in the administration of intercepts. For example, the Ministry of Finance may make automatic payments to the commercial lender from a city's allocation of a shared tax, and then transfer only the residual funds remaining to the local government without any clear accounting for the intercept. To guard against this type of problem, it is important:

- That the local government not only enter the intercept arrangement voluntarily, but be in control of negotiating the specific terms and conditions;

- That there be clear conditions for when the intercept would be activated; the intercept should only operate to cure defaults, not to substitute for regular payments from the local treasury to the lender;

- That at a minimum, the central government be obligated to provide a clear accounting for any intercept funds diverted to a lender. Alternatively, intercepts can be administered through some special fiduciary arrangement established at the local level.

Moreover, to discourage municipalities from over-reliance on the intercept to cover delinquent debt payments, consideration should be given to imposing a financial penalty on the municipality each time a lender utilizes the intercept to cure a default.

Example of language on securing debt with own source revenues

Republic of Lithuania, Decree on Usage of Bank Credits by Local Authorities, 1998

14 – When taking a loan, the municipality must guarantee its repayment only by the means of the municipality budget, and the municipality enterprise, only by the assets, which could serve as a source to recover the loan.

Romania, Local Public Finance Law, 1998

49. - (1) The due instalments deriving from the contracted loans, the interest and commissions due by territorial administrative units, shall be provided in the local budget.

(2) The loans contracted by territorial administrative units can be guaranteed by the local public authority, from any revenue source, with the exception provided under 48, paragraph (3). Any guarantee by revenues is valid and shall apply from the moment the guarantee is offered; the revenues representing the guarantee and which are collected by the local budget shall be subject to the respective guarantee agreement, which shall apply with priority against any other request of third parties addressed to the respective local public authority, irrespective of whether these third parties are aware of the guarantee agreement or not. The document through which the agreement of guaranteeing through revenues is concluded must be registered with the city hall or with the respective judet Council, and with the debtor.

(3) All loan agreements concluded according to the provisions of this law shall be considered as fully authorised and shall constitute obligations to be enforced on the respective local budgets.

- To preclude any question of implied central government guarantee arising in the future, The Law on Municipal Credit (and other necessary legislation) should state that no central government guarantee is to be inferred for such credit unless there is explicit central government authorization. The *Municipal Credit Law* should require that each municipal debt instrument contain a statement on its face that there is not any express or implied central government guarantee and that the instrument does not represent any obligation of the central government. (An exception to this imperative would be made in the presumably rare instance when the government may choose to issue an explicit guarantee.) See Box below for sample language to this effect from another transitional country in the CEE region.

Example of language stating that municipal debt is not an obligation of the Government

Romania Local Public Finance Law 1998

50. - (1) The local public debt does not represent a debt or responsibility of the Government and it shall be reimbursed exclusively from the revenues though which the respective loan was guaranteed by the authorities of the local public administration.

(2) The documents registering the local public debt shall include a clause through which

the respective territorial administrative unit places itself under the obligation to reimburse the debt, and to pay the interest and the commissions associated with that debt exclusively from the revenues of the respective local public authority; the Government has no payment obligation whatsoever, and the credibility or taxation capacity of the Government must not be used for guaranteeing the reimbursement of the debt contracted by the territorial administrative unit or of the payment of interest or commissions associated with that debt.

(3) The documents registering the local public debt which do not comply with the provisions under paragraph (2) shall not be considered as valid.

4.6. Disclosure.

10(3) of the Municipal Budgets Act provides that transactions in issues of securities and bonds shall be carried out by procedures under the Securities, Stock Exchanges and Investment Companies Act 1995 (SSEIC Act), as amended. As noted above, since the research for this report was completed, the SSEIC Act has been replaced by a new Law on Public Offerings of Securities which took effect January 30, 2000 and which was substantially amended as of June 25, 2002, including the introduction of specific disclosure requirements for bond issues. (Securities Act). This Act, as did its predecessor, sets rules for all shares and bonds offered to the public. The threshold for an offering to be considered "public" (and come under the purview of the Act's requirements) is that it be extended to at least 50 persons. Section (4). It should also be noted that the Securities Act (as did the SSEIC Act) allows for private placements (i.e. offerings to fewer than 50 investors), but does not regulate them. Thus the requirement of 10(3) of the Municipal Budgets Act that the SSEIC Act requirements be followed[21] has no specific content with regard to private placements of municipal bonds at the present time.

Both the *SSEIC* and the *Securities Acts* provide only for general disclosure requirements which apply to all public securities registered through the SSEC. The two Acts, and the Ordinance on Public Offer Prospectuses and on Disclosure of Information by Public Companies and Other Issuers of Securities, enacted pursuant to the Securities Act, establish initial and continuing disclosure requirements for public offerings (including municipal securities), including requirements for a prospectus to be reviewed and approved by the Securities and Stock Exchange Commission (SSEC). (*See Title Two, Section Six of the Securities Act, "Initial Offering of Securities.")*

The SSEC, prior to the adoption of the Securities Law, adopted regulations setting forth guidelines for municipal disclosure. At this point in time, the preexisting regulations need to be reconciled with the requirements of the new Securities law.

[21] which should now be read as a reference to the new and amended Securities Act.

4.6.1 Recommendations

Disclosure for Public Offerings*.* Clear, fair, and enforceable disclosure requirements are central to municipal credit market regulation and efficiency. They also have an impact on the costs of bond issuance and the willingness of private financial advisers and other financial intermediaries to take on the entrepreneurial risks of bringing municipal offerings to the market. Standardization in the disclosure requirements themselves (and predictability, timeliness, and professionalism in the review process), will go far towards encouraging municipalities and their advisors to invest the time and resources involved in successfully preparing and marketing a bond issue.

The SSEC's disclosure requirements for public offerings of municipal bonds should be reviewed in connection with the requirements of the new Securities Law, and in particular the new Section V that sets disclosure requirements for public bond issues. Such disclosure is important if the market is to act efficiently and for prospective investors to make informed decisions particular in regard to the nature and level of risk involved.

In designing disclosure regulations attention must be given to what information needs to be disclosed by whom, to whom, and when.

Scope of Pre-Sale Disclosure*.* In respect to the content of pre-sale disclosure, the following are illustrative of the range and types of information which investors should receive. The existing SSEC Ordinance covers the first two points below.

- Local government financial condition: budget characteristics (for two or three year period, including current); Description of off-budget accounts; all outstanding debt and other liabilities;

- Information relevant to assessing the quality of security pledged for repayment;

- Characteristics of the local economy's structure and performance that significantly affect risk and prospects for repayment—for example, if local economic activity is highly concentrated in one or two large firms, then future tax revenues may be highly sensitive to the health of their business;

- Tax collection efficiency and (when applicable) fee collection efficiency; and

- Any contingent guarantees extended to Municipally Owned Companies; other pertinent interrelationships between the municipal government and MOCs.

Somewhat different or additional requirements would pertain:

- To revenue bonds issued to finance a specific project with repayment predicated on the project's finances or a specific, related revenue source—rather than the creditworthiness of the municipality as a whole.

- Bonds issued on behalf of a Municipally Owned Company as opposed to a general purpose, local government.

Disclosure By Whom and When*.* The above type of requirements apply to the type of information to be provided in advance of sale to prospective purchasers of the given bond issue. Additional requirements would specify information to be filed upon actual sale of the securities. The regulation would also establish continuing disclosure requirements that would remain in effect until the debt is retired (most importantly, the borrower's obligation to inform the investors of any significant change in circumstances that would adversely affect the likelihood of timely repayment). The Ordinance presently provides for such information.

Some thought should be given as to whether the responsibility (in legal terms) for the quality and accuracy of disclosure rests with both the municipal entity itself and with the financial advisor or underwriter assisting with the bond issue—or primarily with the municipal issuer alone. The Ordinance presently provides that the mayor and investment intermediary are responsible for the veracity of the prospectus, and must sign a declaration to such effect.

Disclosure for Private Placements*.* The primary legislation regarding municipal credit should specifically permit private placements, with standards to be set by the SSEC pursuant to the Securities Act. Private placements are more flexible and usually lower cost than public offerings. For instance, Poland has had more than 100 private placements of municipal bonds but only one public offering of such bonds.[22]

The securities law in Bulgaria, as in many countries, contains no disclosure mandate for private placements of any kind. The premise for this omission is that private investors are "sophisticated" enough to ask the right questions, make informed decisions, and protect their own interest without regulated disclosure. Leaving private investors unprotected has proven workable when (as in the United States) the underlying law defines a series of tests for private investors to qualify as "sophisticated". In some transitional countries like Poland, problems have already arisen with unregulated offerings to small numbers of investors on a private basis. The Bulgarian SSEC might adopt some minimal disclosure requirements for private placements as well. These disclosure requirements should be simpler than those imposed for public placements. The disclosure documents should be self-certified for accuracy by

[22] Here it should be noted that the threshold for a public placement in Poland is an offering made to 300 or more prospective investors (as opposed to 50 or more in Bulgaria). The question of whether, in the interest of increasing transactions, Bulgaria's threshold should be raised, is one for overall securities market policy to address.

the issuer and filed with the SSEC, but without any review and approval process. This would serve the valuable purpose in an emerging credit market of setting minimal standards for disclosure, but without creating a two-tier disclosure review and approval system that would negate the purpose of distinguishing public from private placements in the first place.

NOTE: To administer municipal bond disclosure requirements effectively, the SSEC will need to build the staff capacity to understand and review the offerings and disclosure statements on a timely basis. This will require professional skills in municipal and MOC finance and operations as well as in project specific financing for municipal infrastructure.

4.7. Prudential Investments of Proceeds.

An important element of municipal credit analysis is the type of investments that are permitted for:

- the proceeds of a borrowing pending their application to the permitted purpose, and

- any funds that are held for the purpose of paying debt service., including reserve funds

The investment of "excess funds" of municipalities is presently limited to government securities and time deposits of banks in which the funds are on deposit. (Municipal Budgets Act, 23). The Constitutional Court has partly abolished this provision in 2001 with regard to the word “government.” This would create a very liberal investment option for municipal funds.

It is apparently the practice to interpret "excess funds" to include the proceeds of borrowing.

4.7.1 Recommendations. With the decision of the Constitutional Court, the requirement has been transformed from a relatively restrictive policy to a very broad policy, permitting almost any type of security.

The term "prudential investment" might best be defined in an Ordinance, to reflect the changing availability of financial instruments. However, the investment of municipal funds should minimize credit risk and eliminate liquidity risk.

4.8. Lender Remedies in Case of Default.

4.8.1 Standing to Pursue Remedies. In the event of a default on a municipal bond issue, present law leaves bondholders to pursue remedies on an individual basis. Under most circumstances, this would prove impractical and needlessly costly and time-consuming to all parties involved. It also can constrain the type of collateral pledged since it may suggest that collateral must be in a highly liquid form that would allow each bondholder to readily take possession of his share.

4.8.2 Form of Remedy*.* With the exception of the right to perfect pledges discussed above, the present legal framework appears to offer lenders to municipalities remedies in the event of default that appear adequate and appear comparable to those available for loans to private parties.

The rights to property, the rules of contract and obligations and the rules of foreclosure are set forth in the existing legal framework. (*Ownership Act, Obligations and Contracts Act of 1950, as amended,* and *Code on Civil Procedure 1950*, as amended.) The basic rules for holders of pledges and mortgages are set by the *Obligations and Contracts Act (s 149-182)*. Under *160*, a creditor with a pledge may petition the court for a writ of execution on the basis of its contract. The rules for issuing writs of execution for mortgage deeds are set by *s 173 to 179*.

The rules for foreclosure procedures themselves can be found in the *Code on Civil Procedure. Part Four* concerns *Collateral Security Procedures (s 308 to 322)* and *Part Five* covers Execution Proceedings. *(s 323 to 423).* The writs of execution proceedings with regard to real property are found in *s 373 to 389.* The rules regarding claims for performance of financial debts generally are found in *s 337-422.* Under *337*, the claimant may ask performance against any one property of the debtor. However, that property and rights must be liable to compulsory performance under other legal acts, as is not possible with regard to municipal public property. *(339).*

The system of enforcement through writs of execution seems clear to market participants, but rarely does this system proceed through its final steps. In practice lenders tend to prefer negotiated settlements, often because it would be difficult to sell the property foreclosed.[23] Thus there has been little, if any, experience with municipal default and court ordered, foreclosure of municipal private property. In fact, in the research for this report we learned of only one case of a non-performing municipal loan and that was paid within thirty days of its due date. The substantive and procedural defects of the enforcement system, if any, may only become apparent when there has been more experience with the enforcement of creditor remedies.

4.8.3 Recommendations. The type of well designed state transfer intercept recommended earlier, can provide lenders a more practical and reliable remedy in the event of default than enforcement of their rights through court action (or threat of such action).

[23] In practice, writs of execution have been obtained against municipalities under the above provisions to collect debts owed to vendors and with regard to defaults on loans. However, the collection of moneys based upon such writs appears to be at the discretion of the municipality. In many cases, agreement is reached before a final judicial ruling.

Based on the above, at this time there does not appear a need for a municipal credit law to deal in detail with the type of lender remedies available pursuant to the commercial code and other civil procure legislation. However, in respect to the bondholders' standing to act in the event of default, the legal framework law should permit them to act in an organized and effective manner to enforce their rights. This means that bondholders should be granted the right to pursue remedies in concert, and to be represented by a designated representative to act on their behalf who would have the recognized legal authority to do so. And these rights should be cited in the bond documents themselves.

4.9. Central Government Approval, Monitoring and Intervention

4.9.1 Prior Notification and Approval of Municipal Debt Issuance. Present law does not explicitly require a municipal government to notify the Ministry of Finance before it borrows from a commercial source or to obtain the Ministry's prior approval. In practice, however, a municipality considering the issuance of debt tends to coordinate and consult with the MoF.

Any financial obligation of a municipality that may result in the financial obligation of the State to foreign creditors (e.g., a guarantee) must be approved by a resolution of the National Assembly on a motion introduced by the Council of Ministers (Municipal Budgets Act, 40(5)). In the event that the central government were to guarantee a municipal debt financed from domestic rather than foreign sources, then the Ministry of Finance, in the process of issuing its guarantee, would likely be approving the underlying transaction. However, this conclusion is not based on an explicit legislative requirement but merely the common sense conclusion that such approval would be a precondition for issuing the guarantee.

The Law on Transactions in Foreign Exchange Valuables and Currency Control (12) (in effect until the end of 1999) required MoF approval for all rights and liabilities regarding foreign currency, unless otherwise provided in another law or by an act of the Council of Ministers. This requirement applied to any municipality seeking to issue its debt in a foreign currency. However, the new Foreign Exchange Act of 1999 (in effect from January 1, 2000) only subjects lending between local and foreign bodies to registration at the Bulgarian National Bank (see 4(2)).

4.9.2 Monitoring of Municipal Financial Condition. At present, monitoring of municipal compliance with legal requirements applicable to municipal debt and of municipal finance affairs generally (with intervention as needed) is done the State Financial Control Agency pursuant to the State Internal Financial Control Act[24] and by the Supreme Chamber of Control attached to Parliament (pursuant to the *Audit Office Act*). The State Internal Financial

[24] Effective as of 2001, repealing the State Financial Control Act.

Control Act establishes systems for financial management and control, internal audit performed by the State Financial Control Agency and preventive control.

As the role of the audit agencies is not to monitor outstanding debt of the local sector, this task would normally come under the responsibility of the Ministry of Finance. However, the local government budget department of the MoF does not appear to routinely request information on amount and conditions of outstanding loans of local governments; the data, which is routinely available through budget reports, includes the annual amount of interest and principal payments.

At present, no form of oversight exists that would allow the central government to identify and possibly act in advance to delay or prevent a municipality from going forward with a loan that it clearly could not afford. In practice, and given Bulgaria's commitments to the IMF in respect of public sector debt and deficits, there is some justification for MoF oversight of both the extent of deficits at the local level and the amount of debt contracted by local governments.

To date, one country in the CEE region, Poland, has established strict limitations on local government borrowing in preparation for EU accession, Nevertheless, the actual monitoring procedure is not spelled out in Law on Public Finances (see Box below).

Restrictions and Monitoring of Public Sector Debt in Relation to GDP

The Case of Poland[25]

Poland's Public Finance Law of 1998 introduced new cautionary limits on local government borrowings, in preparation for accession to the EU, and the necessity of monitoring and controlling the consolidated public sector debt.

The first limitation concerns the total outstanding debt stock of a local government, now limited to 60 percent of annual revenues (which is an extremely conservative limit, especially for large cities with strong fiscal bases).

The second limitation sets "cautionary limits" on local government borrowing if consolidated public sector debt exceeds 50 percent of GDP. In this case, the maximum borrowing of each local government cannot exceed the relationship between planned state revenues and planned state deficit for the fiscal year. Thus, if the state limits its borrowing to 10 percent of its current revenues, no local government can borrow more than 10 percent of its planned revenues. In the case the 50 percent is exceeded and the state decides to balance its budget, then no local government would be able to borrow anything at all.

[25] This discussion is adapted from *The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland: 1989-99.* Tony Levitas, Research Triangle Institute. July 1999. Prepared for USAID / The Urban Institute.

4.9.3 Recommendations. Caution should be exercised imposing prior central government review and approval for the issuance of municipal debt (other than for reporting and conformance with the disclosure requirements of the *Law on Public Offerings of Securities*). For the reasons cited there, the proposed Law on Municipal Credit would not provide for any advance MoF judgement on the financial soundness of a pending municipal borrowing. Nor would it provide for national level restraint on aggregate municipal debt nation-wide—at this point in time when the scale of municipal debt remains negligible and the few, creditworthy communities should be encouraged to consider using private credits to finance their investment needs. However, the proposed law should require timely notice to the MoF both at the time of the initial issuance of any municipal debt and in the event of a serious default on a municipality's debt obligations. [and perhaps approval in the certain limited cases described above?]

Advance Notice of Borrowing. The law should direct municipal borrowers to notify the Ministry of Finance when a debt issue is imminent. This notice should be accompanied by certification and documentation that the terms of the pending credit will not cause the municipality to exceed the statutory debt limit. Such notification would allow the MoF to maintain a current inventory of outstanding municipal debt, for purposes of both:

- Enforcing the municipal debt service limit itself.
- Monitoring aggregate municipal borrowing in conjunction with overall public debt management.

This current inventory could also be updated annually through improved municipal debt reporting practices. Moreover, it could also be maintained as a public registry open to prospective lenders to assist them in their due diligence when underwriting municipal credits.

Notice of Default. The law should stipulate that, in the event of a default on a municipal credit, both the municipality and the lender must give the central government "notice" of said default if the delinquent payment has not been made within 30 days of its due date.

4.10. Joint Associations of Municipalities.

The financing and operation of many projects are often more efficiently accomplished on a scale that is larger or more regional than an individual municipality can accomplish. Joint associations of municipalities to finance and operate such projects are a legal form that has been successfully utilized in many economies to achieve this goal.[26]

[26] In Latvia, the legal status of cooperation is determined by the Law on Self Government that determines the right of self-governments to cooperate. Since it is not determined in the legislation that institutions commonly established by self-governments can be juridical persons with their own budget, then the problem arises with receiving credits and may result in each participant having to do its own

The Constitution[27], recognizes the rights of municipalities to 'associate" on the basis of agreement to finance projects jointly.

Notwithstanding such legal authority, there is a need for the development of a legal and contractual framework for such projects that will not only permit municipalities to work together on projects but to do so in a manner that will facilitate the ability to access financing jointly for such projects.

4.10.1 Recommendations. Joint Associations should be authorized by law to exercise the same legal authority as are common to its members, expressly providing that such associations may incur debt "on behalf of its members" in the same manner as its members. Each member of the association would authorize its share of such debt in accordance with the legal provisions covering debt.

4.11. Municipal Insolvency.

There are comprehensive bankruptcy provisions in the Commerce Act, (Part 4, Sections 607-760) which apply to municipal enterprises, as commercial companies. Municipalities are exempted from these provisions because they are not merchants as defined in the Commerce Act (see Sections 1 and 2). Therefore, there is not at present a system (law or established procedures) for dealing with the affairs of an insolvent local government and its relationships with creditors (or of a subsidiary municipal enterprise whose financial problems may have precipitated the insolvency). It should be noted that the lack of a system for addressing municipal default is not unique to Bulgaria; there are currently only two countries in Central and Eastern Europe that have elaborated specific procedures to address municipal default: Hungary and Latvia. Romania's Local Public Finance Law includes some provisions to deal with municipalities who have defaulted on their loan obligations. Few, if any, Western European countries have directly addressed the issue in their respective legislation.

A municipality which defaults on debt and other payments has likely overestimated its financial capacity, allowed expenditures to increase at a faster pace than revenues and in general, has poor financial management. In order to build a stronger financial base, such a local government likely requires assistance and support to establish good financial management policies and practices.

4.11.2 Recommendations. Law and procedures should be developed for managing the affairs of an insolvent municipality and its relationships and rights

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financing. Without such authority in the jointly created entity much of the efficiency of a joint enterprise will be lost.

[27] 137 of the 1991 Constitution states that municipalities shall be free to associate in the solution of common matters, based on conditions set by law."

with regard to creditors, and the priorities among them. The procedure should also include establishment of a set of policies to assist the local government to regain a stable financial position. Such procedures could build on some of the ideas of the 2000 budget protocol, but will also need to operate in a system with greater incentives and hard budget constraints for responsible municipal financial management, as proposed in the preceding sections. Depending on the rules that are adopted, such procedures could be initiated by the council of Ministers, the local government itself, or eventually the municipality's creditors. The definition of municipal insolvency, as well as the rules and conditions under which a procedure to address municipal insolvency may be engaged should be very clearly determined.

Examples of the processes established in Hungary, Latvia and Romania are provided below. They are very different; Hungary relies on the court system, with almost no actions by the Ministry of Finance or the Ministry of the Interior (responsible for overseeing many local Government Issue in Hungary). The process in Latvia relies more on the Ministry of Finance. In both cases, a supervisor or trustee is appointed to assist the municipality to prepare a financial remediation program and to supervise implementation of this program. Both Latvia and Romania offer the possibility of low- or no-interest financial facilities to aid in implementing the financial stabilization program. In France, a form of financial stabilization procedure (financial protocol), including increase in rates of local taxes, and reduction of expenditure, is often required by the Crédit Local de France as a condition for additional guaranteed loan financing for local governments in difficult financial positions.

Example of Procedure for Debt Adjustment and to Address Municipal Insolvency - Hungary

Note: This text describes the debt adjustment / municipal bankruptcy process for Hungarian municipalities, based on the provisions of the 1996 Municipal Debt Adjustment Act.

The debt adjustment process may be initiated by either the municipality or by its creditor, through a court petition. The condition for meeting a 'default' situation is defined from the point when an invoice or call for payments, or an acknowledged debt has not been paid within 60 days, or an obligation required by court decree is not met, or an obligation resulting from a previous bankruptcy decree is not paid.

Once a series of notification conditions have been met by the mayor / city council and the creditor, and the court determines that default conditions do exist, a financial trustee is appointed by the court. Among the responsibilities of the financial trustee is to monitor the business operations of the local government and ensure the provision of mandated public services. All obligations and payments must be signed by the financial trustee. In addition, the bank of the local government cannot enforce any liens or make payments without the countersignature of the trustee.

Legal consequences of the debt adjustment process from the point of view of creditors include the following:

-All debts become due;
-All claims continue to accrue interest and penalties;

-Debts must be reported within 60 days to the financial trustee; if a creditor misses the deadline, an extension is not possible and there can be no enforcement of the debt until 2 years after completion of the adjustment process then under way.

The actions of the municipality are severely limited once the debt adjustment procedure has been initiated. In particular, the municipality may not:

-Assume additional debt;
-Create new enterprises;
-Purchase ownership interests in enterprises.

A debt adjustment committee is formed, composed of the financial trustee, the mayor, the notary, the head of the council finance committee and an additional council member. The committee prepares a draft emergency budget, including the detailed listing of mandatory public functions and their financing. However, even in this sphere there are severe limitations, as the emergency budget will not fund public health, social and educational facilities with a usage rate of less than 50 percent, or facilities whose costs are more than 30 percent higher than the national average.

Compromise negotiations are initiated to define the reorganization program and the debtor-creditor agreement. The compromise is submitted in writing to the court. If it meets the requirements of the Act, the debt adjustment procedure will be completed and the compromise published in the Enterprise Registry. The implementation of the compromise may be supervised by the financial trustee. A compromise agreement may include liquidation of some assets of the local government.

Example of Procedure for Financial Stabilization to Address Municipal Bankruptcy - Latvia

Note: This text describes the financial stabilization/municipal bankruptcy process for Latvian municipalities, based on the provisions of the 1998 Local Government Financial Stabilization Act.

The Local Government Financial Stabilization Act lists three conditions which may be the basis for financial stabilization action: 1) the inability of the local government to settle its debt commitments; 2) a value of debts which exceeds the market value of local assets; and, 3) a debt service ratio greater than 20 percent.

A financial stabilization process may be initiated by the troubled local government, on recommendation of the chairman of the municipal council, the Minister of Finance, the Minister of Special Assignment, or the State auditor. The municipal council must adopt (or reject) the proposed application for a stabilization plan. In case of rejection, the Cabinet of Ministers may determine that the local government should nevertheless enter a stabilization program.

The Stabilization Act directly proposes different options which local governments should review while carrying out their stabilization plan: improving tax collection capacity; promoting regional development; advancing the question of amalgamation[28]; privatization of municipal assets; and, identifying cost efficiencies to reduce local expenditures.

A Supervisor is appointed to assist the local government in developing and implementing a Stabilization Program. The role of the Supervisor includes making proposals to improve the budget (which should include finding cost efficiencies to reduce local expenditures), proposing amendments to the Stabilization program, monitoring budget implementation to ensure compliance with the terms of the Stabilization plan. At the request of the Minister of Finance, the Supervisor can also control all municipal expenditures and sign the municipality's payment orders.

Example of Procedure to Address Municipal Debt Default: Romania

Note: This is the text of 54 of Romania's 1998 Local Public Finance Law.

54. - (1) The activity of the authorities of the local public administration shall be subject to exceptional check ups run by the Court of Accounts, according to the provisions of this , in the following circumstances:

1) The local public authority does not reimburse all its short term debts by the end of the fiscal year during which the loans were contracted;

2) If at a certain moment during the fiscal year the short term debts of the local public authority are higher than the limit specified under 53, paragraph (2), point 1).

(2) The Court of Accounts shall request to the local public authorities which fall under one of the conditions specified under paragraph (1) to draw up and submit a remedy plan according to which the local public authority binds itself to comply with the provisions of 53, paragraph (2) within twelve months.

(3) The Ministry of Finance can grant loans to local public authorities running the remedy plan, out of the available funds in the general account of the state treasury, provided the local public authority binds itself to reimburse these funds within a term set up by the Ministry of Finance, but not longer than two years.

[28] This is an issue specific to Latvia, a country with 2 million inhabitants and over 500 local governments. Current policy is to encourage rural towns to merge.

SECTION 5: OTHER FINANCIAL SECTOR LAWS AND REGULATIONS

In the near term, the commercial banks remain by far the most important prospective source of private capital for the municipal sector, but with the pension and insurance industries poised to grow in importance over the years ahead. Reference has been made above to the need for disclosure requirements in the laws and regulation that govern participation in the securities markets for all participants. This section turns to the laws and regulations that directly regulate each of these three classes of financial institutions, individually. At the outset, however, it should be noted that here the study did not identify any major problems *specific* to municipal credits, per se. Rather, the constraints identified apply more generically to all types of secured lending.

5.1. Banks.

Although the volume of bank lending to municipalities to date is small, banks face no restrictions on the portion of their portfolios that they can allocate to municipal loans (or bonds). Several municipal officials interviewed for this study reported having given up on negotiations for banks loans because of what they perceived as unreasonably high requirements for collateral relative to loan value—cited as often being in excess of 200 percent.[29]

Banking Regulation No. 9, *on the Evaluation of Risk Exposures of Banks and the Allocation of Provisions to Cover the Risk Related Thereto.* This regulation sets up a classification system relating to the "level of risk" exposure to the bank, primarily based on the period of time for which payments are in arrears. 13 of this regulation allocates various reserve requirements for banks depending on the level of risk exposure, ranging from 3 percent for standard risks to 100 percent for risks that have been determined to be a "loss", i.e., more than 180 days past due. These reserve requirements were repeatedly mentioned by representatives of the banking community in our interviews as substantially adding to the cost of making loans. At the same time, the reader should note that the Bulgarian National Bank (BNB) adopted these regulations in response to the financial crisis from which the country has only recently emerged, and that they are given credit, with some reason, for the relative stability and solvency that the banking sector has enjoyed over the past several years.

The substantial collateral and reserve requirements could, in the future, tend to make the purchase of municipal bonds more attractive to banks than

[29] The collateral level for municipal loans is typically set at 125 percent of the loan value. (see 14 of Regulation No. 8 on the Capital Adequacy of Banks issued in 1997.) However, in practice according to a number of interviewees, the lender will then value the collateral at 50 percent of its market value. The apparent result is that short-term municipal loans issued for less than one year may end up being secured by mortgaged real property with an actual value of almost two and one-half times the loan value.

primary lending to municipalities. To date, the bonds being issued have been unsecured and banks need only reserve against them as "investments" rather than as loans.

As a final note on the above two financial sector controls, it should be noted that they apply to all lending activity, and in no way disadvantage the municipal sector relative to the other economic sectors for which it competes for capital.

5.1.2 Recommendations. On the whole, the type of reserve requirements imposed by the BNB are consistent with typical and prudent bank regulatory practice elsewhere in their provisions for portfolio surveillance and the establishment of loss reserves based on the likelihood of loss. Given the banking industry's recent troubles, the conservatism of these reserve requirements is understandable and does not discriminate against the municipal sector. Perhaps the specific percentage reserve requirements should be reviewed relative to international standards with consideration given to counting a percentage of the market value of liquid collateral as a credit to the reserve requirement.

5.2. Pension Funds.

Under Section 44 of the Supplementary Voluntary Pension Insurance Act, municipal bonds are one of the permitted investments of a voluntary pension fund. Not less than 50 percent of the assets of such funds shall be invested in securities issued or guaranteed by the government, and/or in receivables on demand on bank deposits. Government securities, as defined, include municipal bonds. There is no other limitation on their investment in such bonds.

Also a voluntary pension fund is limited to investing not more than 20% of its assets in one issuer.

5.2.2 Recommendations. The present legal framework regarding pension funds encourages investment in municipal bonds that are prudent investments. A number of the recommendations made above (the adoption of disclosure rules for such bonds, and full range of measures to strengthen the creditworthiness of the municipalities that would issue them) would be major steps in improving their attractiveness to pension fund managers.

5.3. Insurance Companies.

The Insurance Act 1996, *as amended*, permits insurance companies to invest their insurance reserves in low risk instruments that are enumerated in a comprehensive list. *Section 52(1)* of the Act provides that an insurer may invest his insurance reserves only domestically in six types of investment, of which one is bonds issued or guaranteed by municipalities. The law limits such investment to five percent of those reserves. However, present portfolios of insurance companies are comprised basically of State securities and bank deposits. Thus, for the near term, this five percent limit does not pose a practical constraint on the purchase of municipal bonds for inclusion in insurance reserve accounts. Moreover, it should be noted that, on average, insurance reserves for both life and non-life firms constitute just under 50 percent of total insurance company assets.[30] The law contains no restriction on the portion of non-reserve assets that could be invested in municipal credits.

5.3.1 Recommendations. The Insurance Act already provides for investment in municipal bonds. Thus the essential legal prerequisite is in place. As part of any overall review and revision of the Insurance Act that may be forthcoming in the future, the five percent limit (on municipal bonds as a per cent of reserves) might be reviewed and consideration given to enacting a modest increase (perhaps to 10 percent) or to shifting to a limit defined along the more flexible lines contained in the pension fund legislation described above.

[30] Annual Report of Insurance Supervision Directorate, 1998.

SECTION 6: CONCLUSION

Comprehensive municipal debt legislation that exclusively addresses all elements set forth above in an internally consistent manner would substantially benefit the development of the municipal capital markets in Bulgaria. The existing framework, in effect, is a patchwork: one must piece it together from language in a number of collateral laws, many of which only indirectly affect municipal debt. As such, if fails to provide the clear principles and guidelines most conducive to market development. The development of a new, comprehensive law on municipal debt would also offers the opportunity for the "stakeholders" in the municipal credit market to engage in joint policy formulation and consensus building.

As underscored at the outset of this Report, Bulgaria has a unique and timely opportunity to establish a well-conceived policy and legal framework in advance of the market’s development—rather than having to return and implement remedial measures on a retroactive basis.

ANNEX - Municipal Credit Conceptual Framework

DRAFT

THIS DRAFT IS NOT INTENDED TO BE IN A FORM FOR SUBMISSION AS LEGISLATION. UPON A DETERMINATION OF THE PRINCIPLES AND ELEMENTS TO BE INCLUDED IN THE LAW, THE DRAFT WILL BE TRANSFORMED INTO AN APPROPRIATE FORM FOR LEGISLATION AND A DETERMINATION OF EU COMPATIBILITY

SET FORTH BELOW IS A DRAFT DOCUMENT CONTAINING ESSENTIAL ELEMENTS OF A MUNICIPAL DEBT LAW, I.E. THE AUTHORIZATION OF DEBT AND GUARANTIES, AS WELL AS ISSUES RELATING TO DEBT. THESE PROVISIONS ARE SUBJECT TO REVIEW, DISCUSSION AND DETERMINATION OF THE PRINCIPLES THAT WILL BE MOST EFFECTIVE FOR BULGARIA.

MUNICIPAL CREDIT
CONCEPTUAL FRAMEWORK

To regulate the conditions upon which Municipalities may assume debt and to provide for matters connected thereto:

CHAPTER 1

DEFINITIONS

For the purposes of the present law, the following terms shall have the following meanings:

1. Municipality – shall mean any or all of the municipalities legally established by law as the principle administrative and territorial unit where local self-government is exercised, including the City of Sofia.

2. Municipal Council - shall mean a municipal council within the meaning of the Local Self-Government and Local Administration Act.

3. Debt – shall mean a monetary obligation or liability created by a Financing Agreement, note, debenture, bond, overdraft, or the issuance of municipal securities, and unless otherwise provided herein includes a Guaranty. NOTE TO TRANSLATOR: USE THE BULGARIAN TERM FOR "CREDIT" WHERE "DEBT" APPEARS IN THIS DOCUMENT.

   This definition treats guaranties as debt and therefore all the provisions of this law relating to debt will apply equally to guaranties, i.e. authorization procedure, notification requirements and debt limitations etc. If there are certain provisions of the law that should be different for guaranties than for direct debt, such provisions must directly express the difference; e.g. the debt limitation provisions will provide that 100% of the debt service on debt be counted but only [30%] of the debt service on guaranties. Unless expressly provided otherwise, the provisions relating to debt will also cover guaranties.
   This definition also provides that lines of credit will be treated as debt at the time the line of credit is made available to the Municipality even if the line has not been drawn on.

4. Financing Agreement – shall mean a written instrument that sets out the terms and conditions under which a borrower has obtained funds from a Lender, and includes provisions that govern their payment, including any loan agreement, lease, line of credit, installment purchase contract or other purchase arrangement or any other document, pursuant to which a Municipality undertakes to pay the capital cost of property, plant and equipment over time.

   This definition would include "financing leases," i.e. leases of property by a Municipality pursuant to which the Municipality becomes the owner of the property at the expiration of the lease term.

5. Long-Term Debt – shall mean Debt which is payable over a period exceeding one year.

6. Short-Term Debt – shall mean Debt which is payable within the fiscal year in which such Debt is issued..

7. Municipal Security – shall mean any note, bond, debenture or other evidence of indebtedness issued by a Municipality, whether in physical or dematerialized form.

8. Guaranty - is a contingent liability of a Municipality to become the obligor of a financial obligation of another legal person, in whole or in part, in the event the party having the primary responsibility for repayment of such financial obligation, has failed to make payment when due.

9. Event of Default – is the failure of a Municipality to make any payment of principal or interest on Debt, when due, or any other event which may be set forth in the terms and conditions of the Debt.

10. Ledger of Municipal Debt – is a ledger prepared by the Minister of Finance of the Republic of Bulgaria, which shall include all outstanding Municipal Debt.

11. Resolution – is the resolution contemplated by Chapter 2 hereof.

12. Lender – is any person or persons who provide Debt financing to a Municipality, and includes holders of Municipal Securities or any authorized representative of such holders.

13. Public Purpose – is any purpose for Municipal Debt that may be promulgated by regulations issued by the Ministry of Finance, including, but not limited to, any of the following:

    Set forth below are enumerated certain activities that would define facilities that could be financed with Municipal Debt. The list is undoubtedly broader than desirable (e.g. economic activity) but is inserted for purposes of review and discussion.

    - healthcare – out-patient, primary care and hospital service, preventive measures, medic-social cares and sanitary-hygienic activities;
    - education – kindergartens, elementary, primary and secondary education;
    - social support – social care and allowances, housing activities for socially disadvantaged and other social activities of municipal importance;
    - culture – reading houses, theatres, orchestras, libraries, museums and exhibitions, amateur performance, rituals, local habits and traditions;

- maintenance and protection of municipally significant cultural, historic and architectural monuments;
- promotion of municipally significant sports, recreation and tourism; educational and cultural activities for the children and the youth within the municipality;
- public safety and safeguarding the property of the population and the municipality;
- defense and country's armed forces;
- defense of the population in emergency situations, natural calamities, disasters and accidents;
- environment protection and efficient use of natural resources, important to the municipality;
- urban planning and development of the municipality and the villages within it;
- administrative and technical customer services;
- construction, current and overhaul repair and equipment of municipal infrastructure sites of local importance, designated for healthcare, education, cultural, trade, community, sport or household services to the population, living in the respective municipality;
- urban planning and public utilities – water supply, sewage, electricity, central heating, communications, streets and squares, parks, gardens, street lights, greenery, correction of river troughs and gulches, household waste management, public transport, municipal baths, laundries, hotels, garages and cemeteries;
- use of municipal property in performing economic activity and support of enterprises to perform activities, oriented to meet the needs of the municipality and the population and resulting in creation of new jobs;
- establishment of a housing fund for socially poor families;

14. <u>Property, Plant and Equipment – is</u>
    - buildings, land, perennial plants
    - machinery, engineering & technical equipment, manufacturing and non-manufacturing/servicing systems within or outside the construction boundaries of the settlements;
    - internal plants in the very buildings and existing in the parcel lots (without the producing plants); the connections of all the existing plants to underground and overhead street conduits, networks and equipment;
    - pieces of equipment, devices and entire systems within or outside the civil boundaries of the settlements.

    The above definition derives from the Accountancy Act.

<u>Useful Life –</u> is the anticipated term in years of actual use of a depreciable asset.

<u>Total Budgeted Revenues</u> - are the anticipated and collected monetary funds in the municipal budget.

N.B.: The Debt limitation formula contained in Chapter 4, excludes non-recurring debt in the calculation of "revenues."

Total Budgeted Expenses – are the expenses [up to the amount of Total Budgeted Revenues] included in the municipal budget.

OFF-BUDGET FUNDS – ARE FUNDS WHICH ARE RAISED, SPENT AND ACCOUNTED FOR IN OFF-BUDGET ACCOUNTS AND FUNDS, PROVIDED THEY ARE SUBJECT TO I) EXPLICIT PROVISION OF LAW, OR II) A SPECIFIC [WILL] STATEMENT, I.E. DONATION, TESTAMENT, WILL, LOCAL REFERENDUM.

CHAPTER 2

AUTHORITY TO BORROW

1. Procedure for Authorization

a) A Municipality may incur Debt if the Municipal Council has authorized the Debt pursuant to a Resolution duly adopted by the Municipal Council and approved by two-thirds of the members of such Council at a meeting of the Municipal Council that is open to the public.

The issue presented here is whether to require a simple majority of the Municipal Council to authorize Debt or to require a "super-majority" e.g. two-thirds. Although it is typical to merely require a majority of a Council to approve Debt, the requirement of a super-majority might be considered as a means of demonstrating the "political will" supporting the debt. This draft eliminates the current prohibition of the authorization of debt within six-months of an election; requiring a super-majority may ameliorate the concern addressed by that prohibition.

b) The Resolution of the Municipal Council shall authorize the following terms of the Debt and set forth the following information and findings:

i) the principal amount of the Debt;
ii) interest rate;
iii) the form of the Debt;
iv) the maturity and repayment terms;
v) the purpose for which the Debt is being issued and explanation of the compliance with the "public purpose" requirement of Paragraph 3 of this Chapter 2;
vi) the source of security for the payment of the Debt, including a description of any pledged revenues or physical property.
vii) evidence of compliance with the Debt Limitation contained in Chapter 4hereof;
viii) the "Useful Life" of the facilities being financed from the proceeds of the Debt; and
ix) a projection of Total Budgeted Revenues and Total Budgeted Expenses for each year through and including the year in which the Debt is scheduled to be paid in full; including the "material" assumptions on which the projections are based.

c) Notice of the meeting at which the Resolution shall be considered for approval by the Municipal Council shall be published in a newspaper of general circulation within the Municipality not less than fifteen (15) days prior to the date of the meeting of the Municipal Council. Such Notice shall include the form of the Resolution to be considered by the Municipal Council

N. B. The "Law on Public Referendum" provides that within twenty (20) days after the adoption of such a Resolution by a Municipal Council, twenty-five (25%) of the registered voters of a Municipality may submit a petition submitting the Resolution to approval by public referendum. Therefore the Resolution will not be effective until the twenty (20) day period has expired without such a petition being filed.

d) Within ten (10) days of the adoption of the Resolution, the Municipality shall provide notice to the Ministry of Finance and the National Audit Office of the issuance of such Debt. The notice shall contain the Resolution authorizing the Debt.

The information contained in the notices to the Ministry of Finance may become the principle source of information with regard to the state of municipal lending in Bulgaria.

Noncompliance with such a notice provision has been a problem in many countries that have such a requirement. Since making the notice is not a condition precedent to the validity of the Debt, consideration should be given to enforcement of this requirement.

e) Municipal Debt that is not payable in the domestic currency shall be subject to the prior approval of the Ministry of Finance.

N.B. The current Foreign Exchange Act would require such Debt to be registered at the BNB.

2. <u>Nature of the Obligation to pay the Debt</u>

   a) Municipal Debt, unless expressly guaranteed by a separate legal person, shall be the sole obligation of the Municipality to repay in accordance with its terms and conditions. Municipal Debt does not represent a direct or indirect obligation of the Republic of Bulgaria unless the Ministry of Finance has expressly issued a guaranty in connection therewith.

b) The Financing Agreement or the Municipal Security shall set forth the sources of payment that have been pledged to the payment of the Municipal Debt in accordance with the provisions of Chapter 3 hereof.

c) Additionally, unless the Ministry of Finance has issued an express guaranty of the Municipal debt, such Financing Agreement or Municipal Security shall contain in its terms the statement that such Debt is payable solely from the sources described in its terms and is not an obligation of the Republic of Bulgaria.

d) Any Debt instrument that does not contain the provision described in c) above shall not be a valid and binding obligation of the Municipality.

This is a somewhat heavy-handed method of preventing a Lender from making an argument that there was an "implied warranty." The Ministry of Finance will need only to point to the contractual provision, which states that there is not any such obligation. The burden of compliance with this section is placed directly on the Lender. In the event it is not complied with an argument can be made that the Municipal obligation is not valid.
However, it is important to note that this section does NOT prohibit express guaranties of Municipal Debt issued by the Ministry of Finance. This option is necessary to assure access to certain international sources of funding which require the sovereign guaranty.

e) All Municipal Debt authorized in accordance with the terms of this Chapter shall be valid, binding and enforceable obligations of the Municipality, enforceable in accordance with its terms and binding on the existing and all subsequent Municipal Councils.

This section is intended to render confidence to the lending community on the "binding" nature of the obligation upon subsequent Municipal Councils and to eliminate the "political" risk of negating financial obligations incurred by prior Councils. Market confidence in the binding nature of a financial obligation on succeeding legislative bodies is an essential precondition for longer term lending for municipal investment.

3. <u>Purpose of Debt</u>

a) A Municipality may issue Short-Term Debt that is payable within the fiscal year in which it is issued:

i) to temporarily finance cash flow budget deficits, [in anticipation of specific and realistic anticipated income to be received within such fiscal year] provided that such Short-Term Debt is paid within the fiscal year in which it is incurred and shall not be subject to refinancing or other extension beyond the end of the fiscal year in which it is issued; or

ii) to temporarily finance capital investments in anticipation of specific and enforceable commitments for grants or long-term financing.

This is a useful financing option to initially fund construction costs in anticipation of future financing [or grants].

Short-Term Debt listed in i) above shall not be subject to refinancing or other extension of maturity beyond the end of the fiscal year in which it is issued. Any Debt which violates this provision shall not be a valid and enforceable obligation of the Municipality.

This provision is intended to inhibit Lenders from "extending" Short-Term Debt that has been issued for cash-flow financing.

b) A Municipality may issue Long-Term Debt:

i) for capital investment in "Property, Plant and Equipment" that are to be utilized by the Municipality for a "Public Purpose". Such investment may include costs of financial, professional and consulting services directly related to such investment; and
ii) to refinance outstanding Long-Term indebtedness issued pursuant to i) above.

c) A Municipality may issue a Guaranty of debt that is issued to finance Property, Plant and Equipment for a Public Purpose."

This limits the guaranty authority to "public purpose projects. However, there is not any limitation on the type of entity that may be a beneficiary of a Guaranty in order not to limit potential public-private partnership transactions which may involve a Municipal Guaranty of a private entity's debt; or a Guaranty to an international financial insitution, e.g. the EBRD recently made a loan to a enterprise secured by water revenues; since there was legal uncertainty as to the enforceability of the rate covenant against the Municipality, the Municipality agreed to Guaranty the Debt in the event the rate covenant were determined to be unenforceable.

4. <u>Terms of Debt</u>

a) Debt may bear interest at either a fixed rate or a variable rate;

b) Debt may be issued in either the domestic currency or in a foreign currency, provided that any Debt issued that is either calculated, or payable in a foreign currency shall be subject to the approval of the Ministry of Finance [see Chapter 2, para. 1 (d)]; and all calculations as to debt service of Debt issued or calculated in a foreign currency shall be calculated at the official exchange rate in effect at the time the calculation is made.

This provision provides that increasing unfavorable exchange rates relating to outstanding Debt will utilize more of the Debt Limit capacity.

c) Short-Term Debt described in Paragraph 3a (i) of this Chapter shall mature and be payable within the fiscal year in which it is issued and shall not be subject to refinancing or other extension of maturity beyond the end of such fiscal year.

d) Long-Term Debt shall not mature and be payable beyond the Useful Life of the capital investments financed with the proceeds of such Debt; and

e) Debt shall be subject to such prepayment terms as provided in the terms and conditions of its issuance,

Bulgarian practice recognizes the concept of medium-term debt. Consideration may be given to adding that concept to this section.

5. Municipal Securities

a) Authority to issue. The Mayor is authorized to issue, in the name of the Municipality, Municipal Securities in book-entry or in physical form. The Mayor is further authorized to establish and maintain directly, or through a fiscal agent, a computerized system for securities issued as book-entries.

b) Status of Book-Entry Securities. Municipal Securities issued in the form of entries in a Book-Entry System are obligations of the Municipality and are no different than if issued in physical form, except that the issuance, account maintenance, and transactions affecting such Municipal Securities, including redemption, are conducted electronically, utilizing interlinked computerized records held by and through intermediaries, acting as agents or custodians.

c) Status of Physical Securities. Municipal Securities issued in certificated, or physical, form are obligations of the Municipality, and are identified by their series of issuance, distinctive serial number, face amount, and may be in either registered or bearer form. A single Municipal Security may be issued in physical form to evidence collectively other Municipal Securities of the same description issued in book-entry form.

d) Negotiability. Municipal Securities may be negotiable or non-negotiable, i.e., transferable or non-transferable, depending on the terms and conditions of issue.

6. Proceeds of Debt

a) The proceeds of Debt shall be applied "solely" to the purposes authorized in the Resolution. In the event a Municipal Council desires to change the purpose of the issuance of the Debt subsequent to its issuance, the Municipal Council shall amend the Resolution to provide for the amended purpose [with the same vote and publication procedures that have been established for the initial Resolution] and obtain the consent of the Lender to such changes. In the case that the Debt has been issued in the form of Municipal Securities, the consent of the percentage of the holders of Municipal Securities that was established in the original terms and conditions of issuance of the Debt, shall be obtained.

b) The Resolution authorizing Debt may provide that a portion of the proceeds of the Debt shall be held in a Reserve Fund, separate and apart from all other funds of the Municipality, and used solely to make payments on the Debt in the event the Municipality fails to make such payments, all in accordance with the terms and conditions of the Debt.

c) The i) proceeds of Debt, ii) funds held for the purpose of making payments on Debt, including any Reserve Fund pursuant to b) above, and iii) and, any revenues which are pledged to the payment of Debt, may be invested only in [Government Securities and time deposits of banks] which mature prior to the expected date of expenditure of such funds for their authorized purpose.

CHAPTER 3

SECURITY FOR DEBT

1. General Obligation Debt

All Municipal Debt shall be secured as a [general obligation] of the Municipality, payable as a [first claim] from all of the Municipality's lawfully available funds which have not otherwise been pledged to other Lenders pursuant to 2) below. A Municipal Council may agree in the Resolution to raise taxes and charge such rates and fees as shall be lawfully permitted and necessary to provide for sufficient funds to pay the Debt on a timely basis.

All General Obligation Debt shall have parity and equality of status regardless of when they were incurred, and regardless of whether they are in the form of Municipal Securities or Financing Agreements**.**

General obligation debt is intended to be a "general" obligation of the municipality without any specific revenues or other collateral guaranteeing its payment. Lenders of general obligation debt are general creditors of the Municipality without any preferred position with regard to any specific revenues but have a [first claim] on all Municipal revenues which have not been pledged pursuant to 2) below. An issue of clarification is raised as to i) what are the lawfully available general revenues to pay the debt upon an Event of Default, and ii) which municipal operating expenses would be paid prior to creditors (consider defining "essential public services" that must be maintained and the interaction with the mandated priorities of the State Budget Act). The resolution of this issue must also be addressed in the Chapter 6 on Remedies.

General Obligation Debt may be "additionally secured" by collateral described in paragraphs 2 and 3 below.

Additionally, a municipality may agree to charge rates and taxation to the extent lawfully permitted to generate funds available to make payment of general obligation debt.

2. Additional Revenue Security

General Obligation Debt may be secured by all or a portion of [any shared taxes and other subsidies received from the central government], however any such pledge shall not in any way obligate the Republic of Bulgaria to make any such payments to the Municipality. :

The language is intended to provide that a Municipality may pledge whatever shared tax revenues and other subsidies they receive from the central government, but that the Government of Bulgaria is not obligated to provide any mandated amount.

Any such pledge of revenues shall be set forth in the Resolution authorizing the Debt and shall be valid upon [compliance with the terms of the State Pledges Act]

Such pledged revenues shall be held separate and apart from all other funds of the Municipality;

Such pledged revenues shall be applied in accordance with the terms and conditions of the Debt and the Lenders shall have a priority with respect to such revenues as against all third parties, all in accordance with the State Pledges Act

We have been advised that the State Pledges Act needs to be amended for all transactions to provide that the beneficiary of the pledge can be the bondholders that are registered as the holders of the bonds from time to time. This amendment is being pursued by BIBA. The State Pledges Act must also be amended to provide for Municipalities to use it in the same manner as commercial companies.

3. Intercept Financing

A Municipality may provide for additionally securing its Debt with revenues pursuant to 2) above by entering into arrangements to provide for the payment of Debt upon an Event of Default directly from [shared taxes and other subsidies received from the central government] that are payable to the Municipality. Such funds shall be held separate and apart from other funds of the Municipality, shall be subject to a pledge pursuant to Paragraph 2 above, and payable to a Lender in accordance with the terms and conditions of such Debt.

4. Physical Property Security.

General Obligation Debt may also be secured by physical property in the “private domain” in accordance with the terms of the Municipal Property Act. **The notation of mortgage will be in accordance with the Property Register Act.**

5. Additional Security Agreements

A Municipal Council may provide security for Debt by agreeing to:

a) undertake to charge rates, fees, charges, tariffs at a particular level to produce a specified amount of revenues, to the extent permitted by law;

b) operate and maintain an enterprise or other property in accordance with the terms and conditions of the issuance of Debt;

c) effect payment directly from monies or sources that may become available and authorize direct access to such sources to secure payment of the debt;
This provision is intended to facilitate an "intercept financing."

d) deposit funds or pledged revenues with, or for the benefit of, a Lender;
This is necessary to effect the pledge of revenues.

e) specific payment procedures to ensure exclusive or dedicated payment to Lenders, including revenue intercepts, payments into special accounts, or other payment mechanisms or procedure;

f) restrictions on additional debt;

g) have disputes resolved through mediation, arbitration or other dispute resolution mechanisms; and

h) such other arrangements as the Municipal Council may consider necessary and prudent in connection with the issuance of Debt and providing security for its payment.

CHAPTER 4

LIMITATIONS ON DEBT

1. Short-Term Debt.

    a) Short-Term Debt issued pursuant to [Chapter 2, para. 3a(i) above to temporarily finance cash flow budget deficits,[including any refinancing thereof] shall be paid within the fiscal year in which it is issued and shall not at any one time exceed more than [ten percent (10 %)] of "total budgeted revenues".

    b) Short-Term Debt issued pursuant to [Chapter 2, para. 3a (ii) to temporarily finance capital investments shall be included in the limitation set forth in 2 (b) below.

2. Long-Term Debt.

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    a) The principal of Long-Term Debt shall mature and be payable at a date not beyond the "useful life" of the property being financed from the proceeds of such Debt;

    b) The amount of principal and interest due in any year on all Long-Term Debt and Short-Term Debt issued pursuant to [Chapter 2, para. 3a (ii)] of a Municipality shall not exceed [ten percent (10%)] of the Total Budgeted Revenues for the year in which any additional Debt is to be issued.
    This formula tests each future annual debt service against the current year's revenues.

        i) Total Budgeted Revenues shall not include any "non-recurring revenues;
        This is to avoid utilizing non-recurring revenues such as privatization proceeds and subsidies to measure debt capacity.

        ii) The calculation of interest for the purpose of determining compliance with this section shall be based on the interest rate in effect for such Debt on the date of such calculation;

A more conservative alternative would be to require the interest to be calculated at the maximum interest rate permissible on the Debt. However, this would require the negotiation of such a term with the Lender and may substantially inhibit the issuance of Debt.

iii) The calculation of principal and interest due on such Debt in a currency other than the domestic currency shall be calculated at the exchange rate in effect on the date of such calculation;

iv) The calculation of principal and interest due shall include [thirty percent (30%)] of the principal and interest on debt guaranteed by the Municipality; provided, however, in the event the Municipality has made a payment on such guaranty with the last three years, than one-hundred percent (100%) of the guaranteed debt shall be included in the calculation.
The method of calculation of the guaranteed debt shall be the same as for Municipal Debt.

v) Compliance with the provisions of this section shall be determined at the time of issuance on any Debt and subsequent changes in the interest rate or currency exchange rate which may cause the [debt service calculation to exceed ten percent (10%] shall not cause this section to be violated or in any way effect the validity of the Debt that was in compliance with this section at the time of issuance.

c) Long-Term Debt may be issued in excess of the limit in (b) above with the prior approval of the Ministry of Finance.

This exclusion would allow Municipalities with a greater capacity to assume debt to make a case to the Ministry of Finance. Additionally, projects, which may have a positive impact on the generation of revenues or the reduction of expenses in the future, may be considered.

d) A Line of Credit shall be subject to the limitations of this section assuming the full amount of the Line of Credit has been drawn when it is issued and calculated in accordance with its terms of repayment obligation of the Municipality to the Lender.

CHAPTER 5

DISCLOSURE

1. Public Offerings of Municipal Securities.

   Any public offering of Municipal Securities shall be subject to the jurisdiction of the SSEC pursuant to the Law on Public Offerings and shall comply with the disclosure, purchase and sale requirements promulgated by the SSEC.
   In July 2000, the SSEC issued its disclosure requirements for the public offering of municipal securities.

2. Private Placement of Municipal Securities.

   In connection with a private placement of Municipal Securities, Municipal officials shall be required to disclose to the purchasers information, which is accurate in all material respects, and not to omit a material fact necessary for an investor to make an informed investment decision. Any person involved in the issuance of Municipal Securities, including Municipal officials and representatives of financial institutions shall be under an obligation to disclose all material facts.
   Although "private placements" are not within the jurisdiction of the SSEC, the SSEC was supportive of the idea of developing "voluntary" disclosure guidelines to meet the above standard of disclosure. Such guidelines may also assist Lenders in identifying the "material" information they should request pursuant to paragraph 3 below.

3. Bank Lending.

   Lenders shall be entitled to receive all reasonable and related information they may request relating to the creditworthiness of the Municipality.

CHAPTER 6

REMEDIES

1. Upon the continuance of an Event of Default for thirty (30) days, the Municipality and the Lender shall be required to inform theMinistry of Finance and the National Audit Office] within [five (5) business days] thereafter. The Ministry of Finance shall make a notation in the Ledger of Municipal Debt that identifies the Debt as being in default.

2. Holders of Municipal Securities shall be entitled to authorize a financial institution [or other intermediary] to act “as a representative” on behalf of all such holders in connection with the pursuit of legal remedies against the Municipality, all in accordance with an agreement between the bondholders and such financial institution.

3. Upon an Event of Default, Lenders of Debt additionally secured with revenues shall be authorized to immediately take possession of any pledged revenues in accordance with the State Pledges Act which have been pledged to the Debt pursuant to the Resolution, and to apply such revenues in accordance with the terms and conditions of the Debt or any Intercept Agreement, until all of the principal and interest on the Debt has been paid in full.
   This permits the possession of pledged revenues on deposit and future revenues to be received by a defaulted Municipality. The revenues are to be applied in accordance with the terms and conditions of the Debt rather than simply to the payment of the Debt.
   The terms and conditions relating to particular Debt will determine whether the Lender is entitled to “accelerate” the payment of Debt.

4. Upon an Event of Default Lenders shall be entitled to pursue all legally available remedies against the Municipality

5. Upon an Event of Default, the National Audit Office shall request the Municipality to draw up and submit a remedy plan.

CHAPTER 7

MISCELLANEOUS

1. Ledger of Municipal Debt

   The Ministry of Finance shall maintain a Ledger of all outstanding Municipal Debt. The Minister of Finance is authorized to adopt regulations relating to the information to be contained in such Ledger. The Ledger shall be continuously updated by the Ministry of Finance, shall be open to inspection by the public ,and shall be published semi-annually.

2. Authority of Municipal Officials

   The Mayor and any other Municipal officials that are authorized pursuant to the Resolution , shall be authorized to take any actions necessary for, or incidental to, the issuance of Debt in connection with the terms and conditions of the Resolution.

3. Public Information

   All documentation relating to the authorization of Debt, including, but not limited to, the Resolution and any Financing Agreement, shall be public information and available to the public on reasonable terms and conditions.

4. Books and Records

   A Municipality shall be required to keep such records and information necessary to permit the verification of the terms Debt and compliance with the terms of the Resolution, including, but not limited to, the applications of proceeds in accordance with the requirements of the Resolution. Such information shall be public information within the meaning of Paragraph 3 above.

5. Tax Exemption

   Interest on Municipal Debt shall be subject to taxation in the same manner as government securities issued by the Republic of Bulgaria.

6. Conflict of Laws

[List all laws being repealed or amended by the provisions hereof.]
State Pledges Act:
1. To provide for utilization by Municipalities; and
2. To allow the beneficiaries of a pledge to be the bondholders registered from time to time in a registry of bondownership.

In the event of a conflict between the provisions of this Law and those of other laws previously enacted by the national Assembly that contain provisions on, or otherwise affect Municipal Debt, this Law shall be deemed to supersede all such prior laws, except that the validity of any Municipal Debt heretofore contracted shall remain in full force and effect.

7. Effective Date

This Law shall become effective upon promulgation by the National Assembly.